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1998 No. 2

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Economic Commission for Europe

Geneva

ECONOMIC SURVEY OF EUROPE

1998 No. 2

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EXPLANATORY NOTES

The following symbols have been used throughout this *Survey*:

.. = not available or not pertinent

– = nil or negligible

* = estimate by the secretariat of the Economic Commission for Europe

| = break in series

In referring to a combination of years, the use of an oblique stroke (e.g. 1995/96) signifies a twelve-month period (say, from 1 July 1995 to 30 June 1996). The use of a hyphen (e.g. 1995-1996) normally signifies either an average of, or a total for, the full period of calendar years covered (including the end-years indicated).

Unless the contrary is stated, the standard unit of weight used throughout is the metric ton. The definition of "billion" used throughout is a thousand million. The definition of "trillion" used throughout is a thousand billion. Minor discrepancies in totals and percentages are due to rounding.

References to dollars ($) are to United States dollars unless otherwise specified.

The membership of the United Nations Economic Commission for Europe (UN/ECE) consists of all the states of western Europe, eastern Europe and the territory of the former Soviet Union, North America and Israel.

The term *transition countries*, as used in the text and tables of this publication, refers to the formerly centrally planned economies of the ECE regions. *Eastern Europe* refers to the economies of Albania, Bulgaria, Hungary, Poland, Romania, the Czech Republic and Slovakia, Bosnia and Herzegovina, Croatia, Slovenia, The former Yugoslav Republic of Macedonia and Yugoslavia. The *Baltic states* refers to Estonia, Latvia and Lithuania and the *CIS countries* refers to Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

ABBREVIATIONS

ASEAN	Association of South-East Asian Nations
BEA	Bureau of Economic Analysis
BIS	Bank for International Settlements
CAP	Common Agricultural Policy
CBR	Central Bank of Russia
CEE	central and eastern Europe
CEECs	central and east European countries
CETE	central European transition economies
c.i.f.	cost, insurance and freight
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
CPI	consumer price index
DIW	Deutsches Institut für Wirtschaftsforschung
EBRD	European Bank for Reconstruction and Development
EFF	Extended Fund Facility (of IMF)
EMU	economic and monetary union
ERP	European Recovery Progamme
EU	European Union
FDI	foreign direct investment
FIG	Financial Industrial Group
GDP	gross domestic product
GDR	German Democratic Republic
GEMSU	German Economic, Monetary and Social Union
GFS	Government Finance Statistics (of IMF)
HKMA	Hong Kong Monetary Authority
HWWA	Hamburg Institute for Economic Research
ICs	investment companies
IFs	investment funds
IfW	Kiel Institute of World Economics
ILO	International Labour Office
IMF	International Monetary Fund
IWH	Institute for Economic Research Halle
KOB	Konsolidacni Banka
NIEs	newly industrializing economies
NMP	net material product
NPF	National Property Fund
NPV	net present value

OECD	Organisation for Economic Co-operation and Development
OPT	outward processing trade
PPI	producer price index
SETE	south European transition economies
SOCBs	state owned commercial banks
SOEs	state owned enterprises
TACIS	Technical Assistance for the Commonwealth of Independent States
THA	Treuhandanstalt
UNCTAD	United Nations Conference on Trade and Development
UN/ECE	United Nations Economic Commission for Europe
VAT	value added tax

PREFACE

The 1998 volume of the *Survey* is the fifty-first in a series of reports prepared by the secretariat of the United Nations Economic Commission for Europe to serve the needs of the Commission and of the United Nations in reporting on and analysing world economic conditions.

Until now the *Economic Survey of Europe* has been an annual publication as was the *Economic Bulletin for Europe*, the secretariat's second publication which focused on trade and payments issues. At its 52nd Session, in April 1997, the Commission decided to replace these two publications with an annual *Survey* of three issues starting in 1998. The present text is the second issue of the 1998 volume. The first issue appeared in May and the third is scheduled for late November.

This issue contains in Part One a short overview of the economic situation and outlook in the ECE region at mid-year and updates the more extensive analysis provided earlier in the year in the first issue of the 1998 volume. Part Two contains a selection of papers presented to the UN/ECE's Spring Seminar in April 1998 which was devoted to the problems of enterprise and bank restructuring in the transition economies. Part Three consists of a statistical appendix, which will appear in all issues of the *Survey*, of long-run series for the principal macroeconomic variables in the ECE member countries; the tables incorporate the revisions made by national statistical offices and available to the secretariat in June 1998.

The *Survey* continues to be published on the sole responsibility of the Executive Secretary of the ECE and the views expressed in it should not be attributed to the Commission or to its participating governments.

The review of the economic situation in Part One of this issue is based on data and information available to the secretariat at the beginning of June 1998.

Economic Analysis Division
United Nations Economic Commission for Europe
Geneva

PART ONE

CURRENT ECONOMIC DEVELOPMENTS

CHAPTER 1

THE ECE ECONOMIES AT MID-1998

1.1 The global context and the situation in the western market economies

(i) Diverging performance and increasing instability

Developments in the first half of 1998 were marked by the contrast between a deepening economic crisis in East Asia and a continuing economic upswing in the western market economies and the transition economies. In East Asia, the economic and social costs of adjustment to be faced after the turbulence in the financial markets have become more visible in 1998. A significant deterioration of the economic situation in Japan, which moved into deep recession, and the associated sharp depreciation of the yen have seriously dampened prospects for recovery in the region, however. In North America, the economic expansion has continued at a high rate. In western Europe, the cyclical recovery has continued at a moderate pace. Economic developments have also, in general, been favourable in the transition economies, but they are still vulnerable to financial instability as a result of large domestic or external imbalances, real currency appreciation, weak banking systems, and relatively high exposure to short-term capital inflows. The recent financial turmoil in Russia, which erupted in May 1998,[1] is an illustration of these risks.

In the foreign exchange markets the progressive appreciation of the dollar against the yen, underway since April 1995, has continued. Against the background of a marked weakening of economic activity in Japan, concerns over the problems in its banking sector and sizeable interest differentials in favour of dollar denominated financial assets, the selling pressure on the yen mounted considerably. On 8 June 1998, the value of the dollar rose to 140 yen, the lowest value of the Japanese currency since September 1990. On 12 June, the spot exchange rate was 144.36 yen compared with 81.2 yen on 19 April 1995, when the yen peaked against the dollar. Thus, over this period the dollar appreciated by about 78 per cent, equivalent to a yen depreciation of some 44 per cent.

The collapse of the yen exchange rate constitutes a major change in the economic environment facing the east Asian emerging economies, because it has progressively eroded, in combination with a sizeable inflation differential vis-à-vis Japan, the price competitiveness which they had gained from the depreciations of their currencies in the second half of 1997 and in early 1998. In fact, the decline of the exchange rates of the five east Asian countries most affected by the financial crisis had bottomed out in the first quarter of 1998 and in some this was partly reversed (chart 1.1.1). But there were renewed signs of weakness in the second quarter reflecting a combination of specific domestic problems, the decline of the yen and the spillover effects from the political turmoil in Indonesia. In those countries which have maintained the parity against the dollar (China and Hong Kong) the weakening of the yen has considerably increased the domestic economic costs of maintaining a fixed exchange rate against the dollar.

Share price indices in western Europe and the United States rose to record levels in the second quarter of 1998, but there was increasing volatility in May, which was partly related to the political turmoil in Indonesia and to temporary concerns over possible interest rate increases in the United States. This led also to selling pressure on share prices in emerging markets in Latin America and the transition economies. There was renewed volatility in early June against the background of the sharp depreciation of the yen, which was seen as a possible trigger of a new round of currency depreciations in the region. In Japan, the Nikkei index fell below the threshold of 15,000, renewing concerns over the ability of banks to meet the capital adequacy ratio.

The decline of international commodity prices accentuated in the first half of 1998 (chart 1.1.2). This was partly related to the reduced demand originating in East Asia on account of depressed domestic activity levels, but increasing supplies of some commodities have also played a role. There has been a conspicuous fall in the price of crude oil, the world market price (Brent Crude) falling below $14 per barrel in May 1998, some 30 per cent lower than in the same month of the previous year. Oil producing countries agreed in March 1998 to cut output until the end of the year to reverse the slide, but the reductions appear to have been outpaced by the decline of demand. In early June 1998, Saudi Arabia, Mexico and Venezuela announced their intention to make further output cuts. The deteriorating economic outlook for Japan will tend to put further downward pressure on the oil price.

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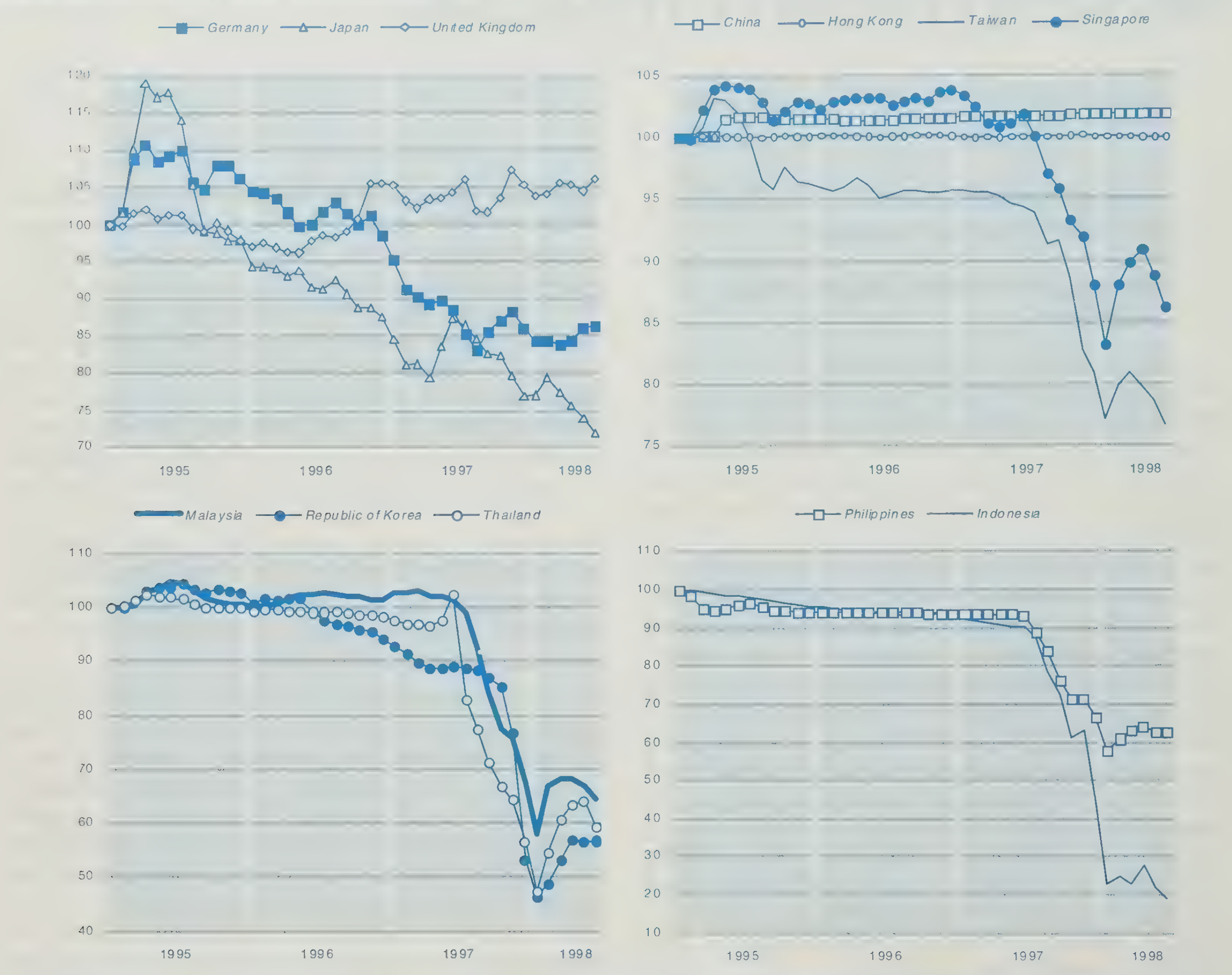
[1] See sect. 1.2(ii) below.

CHART 1.1.1

Average monthly nominal exchange rates against the dollar, January 1995-June 1998
(Indices, January 1995=100)



Source: Federal Reserve Bank of New York; IMF, *International Financial Statistics* (Washington, D.C.); Reuters Business Briefing, online database.
Note: Dollars per national currency unit. Data for June 1998: average of first week.

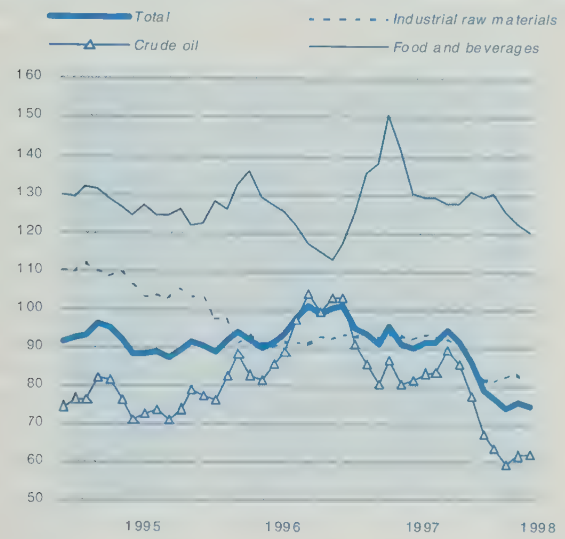
(ii) Economic crisis in East Asia

In Japan, there has been a further significant deterioration of the economic situation, and the economy is now in deep recession. Real GDP fell by 1.3 per cent in the first quarter of 1998 compared with the last quarter of 1997 when there had already been a fall of 0.4 per cent. Economic activity had started to weaken significantly in the wake of the tightening of fiscal policy in April 1997 which, with hindsight, was premature. To this was added the restraining effects of the Asian financial crisis on regional export performance and the lingering balance sheet adjustment problems in the banking sector, which led to a tightening of lending standards. This last factor has made it difficult for small- and medium-sized enterprises to obtain credit. The collapse of some important financial institutions in late 1997 also depressed consumer and business confidence.

Total domestic demand fell by 1 per cent in the first quarter of 1998 compared with the preceding quarter: private consumption stagnated, government consumption fell and there was a sharp contraction of fixed investment by 3.3 per cent. In fact, this was the fifth consecutive quarterly decline of fixed investment. Real exports of goods and services plunged by nearly 4 per cent, reflecting in the main the deteriorating economic conditions in the other countries of the region, since exports to the United States and Europe remained strong. Against a background of depressed domestic demand, imports continued to fall. The latest business survey (Tankan) published by the Bank of Japan points to a significant deterioration in the assessment of the current situation and prospects at the beginning of the second quarter of 1998. In fact, industrial production fell by 1.1 per cent in April and was more than 6 per cent lower than in the same month of 1997. Wholesale prices fell over

CHART 1.1.2

World commodity prices, January 1995-May 1998
(Indices, 1990=100)



Source: Hamburg Institute for Economic Research (HWWA).

Note: Indices calculated on the basis of dollar prices.

TABLE 1.1.1

Annual changes in real GDP in east Asian countries, 1996-1998
(Percentage change over preceding year)

	1996	*1997*	*1998*[a]	*Memo item: 1998-QI*[b]
ASEAN-4	7.0	4.0	-7.4	..
Indonesia	8.0	5.0	-12.0	-6.2
Malaysia	8.6	7.8	-2.5	-1.8
Philippines	5.7	5.1	1.0	1.7
Thailand	5.5	-0.4	-8.0	..
NIEs	6.4	6.0	-1.6	0.1
Hong Kong	4.9	5.3	-2.0	-2.0
Republic of Korea	7.1	5.5	-6.0	-3.8
Singapore	6.9	7.8	1.0	5.6
Taiwan Province of China	5.7	6.8	5.0	5.9
China	9.7	8.8	6.0	7.2
Japan	3.9	0.9	-0.5	-3.7
Total above	4.7	3.5	0.7	..

Source: National statistics and UNCTAD.

Note: Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1996 GDP data converted from national currency units into dollars using purchasing power parties.

[a] Forecasts. Country data supplied by the Division on Globalization and Development Strategies, UNCTAD.

[b] Percentage change over same quarter of previous year.

the same period by 2.7 per cent, while consumer prices rose by a mere 0.4 per cent. Employment in the total economy declined further and the unemployment rate rose to 4.1 per cent in April 1998, the highest rate since 1953, when the relevant data were compiled for the first time.

The Japanese government has reacted to the deterioration in economic conditions by reversing the stance of fiscal policy. A new economic stimulus package of some 16 trillion yen (equivalent to 3.5 per cent of GDP) was adopted in April 1998. The measures comprise, *inter alia*, temporary tax reductions and increased government expenditures on public works. This is the seventh fiscal stimulus package since August 1992, the cumulative value of which amounts to some 80 trillion yen, equivalent to some 16 per cent of GDP. But all these packages have so far failed to trigger a sustained recovery.

Tight macroeconomic policies and depreciations of the real exchange rate are the principal ways for promoting the process of external adjustment in the five east Asian emerging markets most affected by the financial crisis, given that capital inflows are no longer available to the same extent as before. Structural reforms, including reforms of the fragile financial sectors in the various countries, are underway and the adjustment of the real economy is visible for the time being in falling output or a marked slowdown in economic growth, rising unemployment and higher inflation. Tight policies are depressing domestic output and incomes with negative effects on the demand for imports. The expected support to domestic activity levels from higher exports has so far failed to materialize. In general, the modest export performance reflects to some degree the close intraregional trade linkages, which imply that depressed domestic demand in each of these countries has relatively strong negative spillover effects on export demand and activity levels in the other countries of the region. The recession in Japan, the most important market in the region, and the depreciation of the yen have accentuated this mutually reinforcing process of weakening domestic demand and exports. Another factor hampering exports is the difficulties encountered in some countries in obtaining trade financing. Companies are having to cope with tight liquidity and high interest rates. It should also be recalled that the potential gains in price competitiveness from the sharp decline of the exchange rates are offset to a more or less large degree by the increased dollar cost of imported inputs.

Real GDP fell in several of the east Asian emerging markets in the first quarter of 1998 compared with the same period of the preceding year (table 1.1.1). Among the five countries most affected, the downturn was particularly pronounced in Indonesia (6.2 per cent) and the Republic of Korea (3.8 per cent), but aggregate output also fell in Malaysia (1.8 per cent) and most probably in Thailand.[2] For the Republic of Korea, this was the first quarterly decline of real GDP in 18 years and for Malaysia, in 13 years. In the Philippines, there was a sharp slowdown in economic growth.

Among the other Asian emerging market economies, real GDP fell in Hong Kong by 2 per cent in the first quarter of 1998, compared with the same period of the preceding year, and a further contraction is expected in the second quarter. In China, there was a noticeable slowdown in the pace of economic expansion in the first months of 1998. Real GDP in the first quarter of 1998 was still 7.2 per cent higher than a year earlier, but the official target of an annual growth rate of 8 per cent for the year as a whole could now be too optimistic. In Singapore and Taiwan Province of China, developments have been relatively more favourable, real GDP rising by more than 5.5 to 6 per cent in the first quarter of 1998 over the same period of the preceding year.

---

[2] Quarterly GDP data for Thailand are not available.

In all these countries official forecasts for GDP growth in 1998 have been – or will be – significantly lowered. This is especially the case for Indonesia, where a fall in real GDP by more than 10 per cent is now expected following earlier forecasts of a fall by 5 per cent. Private forecasters expect also quite a sharp decline in real GDP in the Republic of Korea and Thailand (table 1.1.1).

In Indonesia, against the background of falling output, soaring inflation (the annual inflation rate was some 50 per cent in May) and a steep rise in unemployment, the government was facing massive protests when it decided to raise administered prices of energy and transport in early May 1998. Although the authorities cancelled this decision, the protests continued and led to the resignation of the President and a change of government. Given the persistent political uncertainty, the IMF suspended disbursement of the loan arranged in the context of the rescue package agreed in October 1997. The Indonesian rupiah, which had recovered somewhat in April, weakened sharply in May, falling to more than 11,500 rupiah against the dollar in early June. This corresponds to a depreciation of the rupiah by nearly 80 per cent against the dollar since June 1997.

(iii) The economic situation in western Europe and North America

Economic developments in the western market economies were generally favourable in the first half of 1998. The expected negative effects of the east Asian crisis on net exports have only gradually started to appear and so far they have been offset by stronger domestic demand. In general, the western countries have so far mainly experienced the beneficial effects of the Asian crisis: falling inflationary expectations have put downward pressure on interest rates and this has supported domestic demand. Falling interest rates have also contributed to the rise in asset prices and, hence, household wealth, which has also been supporting private consumption expenditures.

In western Europe, the cyclical upswing had gained considerable momentum in the second quarter of 1997, when real GDP rose by 1.2 per cent compared with the preceding quarter, equivalent to an annual rate of 4.9 per cent. But the pace of expansion slowed down thereafter to 0.5 per cent in the final quarter of 1997. The recovery was increasingly supported by domestic demand in the course of 1997: export growth weakened significantly in the final quarter and changes in real net exports were no longer supporting overall economic activity. The cyclical desynchronization in western Europe[3] has meant that policy concerns in some countries (notably Denmark, Ireland, Norway and the United Kingdom) have shifted towards avoiding overheating, while in others the focus is sustaining expansion in the presence of low inflation.

At the time of writing, national accounts data for the first quarter of 1998 are only available for a small number of countries. These show an acceleration in overall economic activity in Germany, the Netherlands and the United Kingdom, a slight slowdown of growth in France and Switzerland and a small decline in total output in Norway, albeit at a very high activity level (table 1.1.2). The available data also suggest that industrial production in western Europe continued to rise in the first quarter of 1998 supported by strong gains in France and Germany. In contrast, output stagnated in Italy and fell slightly in the United Kingdom compared with the preceding quarter. Industrial output is estimated to have increased by somewhat more than half a percentage point in the first quarter of 1998 compared with the preceding quarter. Rough estimates suggest that real GDP in western Europe rose by some ½ to ¾ of a percentage point in the first quarter of 1998 compared with the preceding quarter, when there was an increase by 0.5 per cent. This would imply an average year-on-year increase of some 3 per cent (chart 1.1.3).

Capacity utilization rates in manufacturing industry were rising between January and April 1998 and in the European Union industrial confidence remained at a relatively high level in the first five months of 1998, although the overall assessment of the economic situation appears to have deteriorated slightly in April and May. In contrast, consumer confidence generally continued to improve and in May 1998 was at its highest level in this decade.

Inflationary pressures have remained quite low. In April 1998, the average rise in consumer prices was 0.3 per cent compared with the preceding month; the year-on-year inflation rate was 2 per cent.[4] This low figure masks significantly above average inflation rates in Greece and the United Kingdom. In fact, in the United Kingdom the annual rate rose to 4.2 per cent in May 1998; the underlying inflation rate (the index excluding mortgage interest payments) rose by 3.2 per cent, which is nearly ¾ of a percentage point above the government's target.

In the labour markets, the favourable changes in production led to a small decline in the average unemployment rate in western Europe to 9.8 per cent in

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[3] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, sect. 2.2.

[4] Excluding Turkey, where the annual inflation remained above 90 per cent.

TABLE 1.1.2

Quarterly changes in real GDP, 1997-1998
(Percentage change over preceding quarter)

	1997				*1998*
	QI	*QII*	*QIII*	*QIV*	*QI*
Western Europe	0.4	1.2	0.8	0.5	0.5*
4 major countries	0.3	1.2	0.8	0.4	..
France	0.2	1.1	0.9	0.8	0.6
Germany	0.3	1.0	0.7	0.3	1.0
Italy	0.0	1.9	0.6	0.2	..
United Kingdom	0.8	0.8	0.8	0.3	1.0
8 smaller countries	0.6	1.2	0.9	0.9	..
Belgium	0.3	1.3	1.3	-0.4	..
Denmark	0.8	2.0	0.5	1.1	..
Finland	0.0	3.1	1.7	1.1	..
Netherlands	1.0	1.0	0.8	0.9	1.2
Norway	0.4	2.5	0.1	1.8	-0.5
Spain	0.9	0.8	0.9	0.9	..
Sweden	-0.2	0.4	1.0	2.2	..
Switzerland	0.2	1.0	0.5	0.5	0.4
North America	1.2	0.9	0.8	0.9	1.1
Canada	1.1	1.3	1.0	0.7	0.8
United States	1.2	0.8	0.8	0.9	1.2
Total above	0.8	1.0	0.8	0.7	0.8*
Memorandum item:					
Japan	2.0	-2.8	0.8	-0.4	-1.3
Total above, *including Japan*	1.0	0.4	0.8	0.5	0.5*

Source: National statistics; *OECD National Accounts* (Paris), various issues.

Note: Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

the first quarter of 1998, down from 10 per cent in the same quarter of 1997. In the European Union, the average rate was 10.2 per cent in April 1998 compared with 10.7 per cent a year earlier. This average masks a much lower rate of unemployment in the United Kingdom, where after more than five years of cyclical expansion the standardized rate fell to 6.5 per cent in the first quarter of 1998, the lowest rate in this decade.

In Germany, overall economic growth picked up strongly in the first quarter, real GDP rising by 1 per cent over the previous quarter (table 1.1.1). There was a sharp acceleration in manufacturing output growth and capacity utilization rates rose to high levels. The most conspicuous feature was the strengthening of domestic demand, reflecting stronger growth of both consumption expenditures and fixed investment in machinery and equipment. Private household expenditures were supported by gains in aggregate real disposable incomes and some bringing forward of purchases in anticipation of the rise in VAT on 1 April 1998. Favourable financing conditions and declining margins of spare capacity stimulated business fixed investment.

Export growth slowed down in the final quarter of 1997 after a buoyant performance since the second half of 1996. Exports continued to expand at a strong rate, however, supported by the strong dollar and the general upturn of the west European business cycle. Rising domestic demand led to a surge in imports and the change in real net exports was a significant drag on overall economic activity in the first quarter of 1998, a feature which was already present in the last quarter of 1997.

In France, real GDP rose by 0.6 per cent in the first quarter of 1998 compared with the preceding quarter when there was an equivalent increase of 0.8 per cent. Industrial production rose by 1 per cent in the first quarter. Private consumption expenditure was rather sluggish, reflecting weak demand for consumer durables and, possibly, a rise in the savings ratio. Government consumption also remained subdued. The weakness of consumption, however, was offset by stronger fixed investment. In addition, there was considerable inventory accumulation accounting for about 0.5 percentage points of GDP growth in the first quarter. This was probably the major factor behind the considerable rise in imports. In contrast, there was a significant slowdown in export growth, partly reflecting weaker demand from East Asia. The adverse changes in the real foreign balance subtracted about half a percentage point from total GDP growth in the first quarter of 1998.

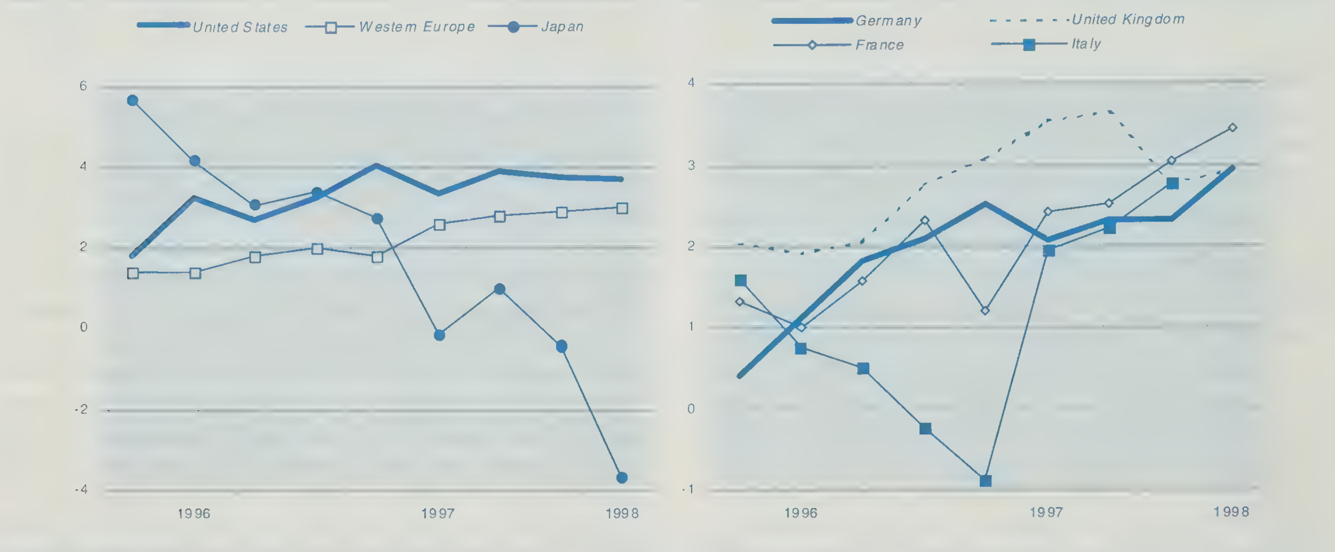
In Italy, economic activity recovered in the course of 1997 with real GDP rising by 1.5 per cent. GDP data for the first quarter of 1998 were not available at the time of writing, but industrial production remained at the same level as in the final quarter of 1997. Capacity utilization rates in manufacturing industry, which had risen strongly in 1997, were unchanged between January and April 1998. The strong rise in the composite leading indicator series in the course of 1997 was arrested in the first months of 1998 and industrial confidence weakened significantly in April/May 1998. Consumer confidence, however, continued to improve.

In the United Kingdom, the pace of economic expansion had accelerated in 1997 leading to a further tightening of labour markets and high capacity utilization rates against the background of a strong pound and a progressive tightening of monetary policy. A striking feature over the past two years has been the sluggish performance of manufacturing industry, which stands in sharp contrast to the buoyant activity in the private services sector. Thus in 1997, real GDP rose by 3.3 per cent, but manufacturing output rose by only 1.5 per cent while production of private services increased by about 6 per cent. The pace of expansion accelerated in the first quarter of 1998, real GDP rising by 1 per cent over the preceding quarter (table 1.1.2), manufacturing output fell slightly, while private services remained buoyant, output rising by 1.1 per cent. Overall economic activity in the first quarter was supported by the strong growth of private consumption expenditure and fixed investment, and by a significant contribution from stockbuilding. Export growth was quite favourable in 1996 and for most of 1997 despite the significant appreciation of the pound. But the lagged effects of the deterioration in price

CHART 1.1.3

Quarterly changes in real GDP, 1996-1998

(Percentage change over same period of preceding year)



Source: National statistics.

Note: Western Europe: Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom.

competitiveness became visible in the final quarter of 1997, when the volume of merchandise exports fell and overall exports of goods and services stagnated. Merchandise exports continued to fall in the first quarter of 1998, reflecting also the weakening of demand in East Asia. There was a further significant deterioration in the real foreign balance, which subtracted half a percentage point from overall output growth.

In the United States, the long expansion continued in the first half of 1998 with a marked acceleration in the pace of activity in the first quarter of 1998, when real GDP rose by 1.2 per cent over the preceding quarter. It is noteworthy that this performance was entirely due to stronger domestic demand growth. There was a rebound of personal consumption expenditures, which were supported by the strong growth of real disposable incomes and a slight fall in the savings ratio. Household spending was also stimulated by further large gains in wealth due to the continuing rise of shares and bond prices. Business fixed investment in machinery and equipment rose strongly following virtual stagnation, albeit at a very high level, in the final quarter of 1997, but expenditures on structures weakened further. In contrast, residential investment gained considerable momentum as a result of low mortgage rates. There was also considerable inventory accumulation which, as in the previous quarter, was a major support of domestic demand. But the potential effects of buoyant domestic demand on domestic activity levels were offset to a large extent by adverse changes in real net exports. This resulted in a substantial negative growth contribution corresponding to ¾ of a percentage point of GDP in the first quarter. This reflects the combined impact of the strong dollar and the differential strength of domestic and foreign demand, and notably the emerging trade effects of the Asian crisis. Exports of goods and services fell by 0.8 per cent compared with the preceding quarter, while imports surged by 4.2 per cent.

Short-term indicators suggest that the overall rate of expansion slowed down in the second quarter of 1998. Manufacturing output rose slightly in April compared with March but was below its level in December 1997. But consumer spending and business fixed investment remained strong and labour markets continued to be tight.

Given the stage of the business cycle and tight labour markets the inflation performance of the United States economy remains striking. The overall consumer price index rose at a steady monthly rate of 0.2 per cent in the first four months of 1998 and producer prices fell in the first three months of the year. The price index for total domestic expenditures, the broadest measure of domestic inflation, did not rise at all between the last quarter of 1997 and the first of 1998. A major reason for this has been the continuing decline in the prices of information processing equipment. The strong dollar also put downward pressure on import prices. It is also noteworthy that in the face of the sizeable appreciation of the dollar, United States firms have steadily lowered export prices since 1996 to defend market shares.

The demand for labour continued to rise in the first five months of 1998. The unemployment rate fell to 4.3 per cent in April, the lowest since February 1970, and remained there in May. Labour cost pressures, nevertheless, have remained relatively subdued. In the non-farm business sector, productivity growth held in check the upward pressures on unit labour costs in 1996 and 1997. But productivity growth was only about ¼ of a percentage point in the first quarter of 1998 compared with the preceding quarter, while unit labour costs rose by some ¾ of a percentage point, equivalent to an annual rate of about 3 per cent. If sustained, this would lead to the largest annual increase in unit labour costs since 1991 and would imply a much stronger upward pressure on prices.

In Canada, the upswing continued in the first months of 1998, but the underlying cyclical momentum has been difficult to gauge on account of irregular weather conditions. Canada is an important exporter of raw materials and has therefore been affected by the weakening of raw materials prices in the wake of the Asian crisis. This appears to have led firms to reduce output levels. Real GDP rose, nevertheless, by 0.8 per cent in the first quarter of 1998. Total domestic demand was relatively weak, with robust private consumption offset by declining government consumption and fixed investment. Exports were the mainstay of economic growth. Employment in the whole economy continued to edge upwards and the unemployment rate fell to 8.6 per cent in the first quarter of 1998, one percentage point less than in the same period of 1997. The inflation rate remained very low and in April was only 0.8 per cent compared with a year earlier.

In the United States, the Federal Reserve has held the federal funds rate unchanged at 5.5 per cent so far in 1998 against a background of moderate inflationary pressures and a very tight United States labour market. This policy stance was influenced by the financial and economic crisis in East Asia and concerns over possible negative spillover effects to the United States economy. It was feared that a rise in United States short-term rates might also have contributed to further exchange rate instability in emerging markets. Nevertheless, given the fall in inflation, real short-term interest rates have edged upward; in April 1998 they were nearly 1 percentage point higher than in the same month of 1997.

Among the members of the future EMU, there was a further easing of monetary policy in Italy, Portugal and Spain in April and May 1998, thus promoting the process of convergence of short-term interest rates towards the lower and broadly stable rates in France, Germany and other member countries, where monetary policy was unchanged. In Ireland, where short-term rates have remained about 2.5 percentage points above German rates in the first five months of 1998, the central bank has delayed any easing of monetary policy in view of the country's buoyant economic growth and fears of overheating.

Outside the EMU area, in the United Kingdom the central bank further tightened the stance of monetary policy in early June 1998, the base rate being raised by 0.25 percentage points to 7.5 per cent. This decision was triggered by concerns over mounting inflationary pressures associated with the strong growth of average earnings and the weakening of the pound. Short-term interest rates in the United Kingdom are now some 4 percentage points higher than in Germany. In contrast, official interest rates were lowered somewhat in Greece and Sweden.

Nominal long-term interest rates (on 10- and 30-year bills) in the United States peaked in April 1997 and fell throughout the rest of the year. In Germany, yields on 10-year government bonds also fell over the same period. The pervasive fall in long-term rates reflected not only reduced inflationary expectations, partly associated with the anticipated deflationary effects of the Asian crisis, but also the "flight to quality" of international investors who increased their demand for equities and government bonds in the United States and Europe. Long-term interest rates fluctuated within a small range in the first five months of 1998. They fell slightly (some 0.1 percentage points) in France and Germany between January and May 1998, but they rose slightly in the United States over the same period. In early June 1998, the sharp weakening of the yen and concerns over the economic outlook in East Asia led to stronger demand for government bonds in western Europe and the United States. Yields on 30-year United States treasury bills and on German 10-year government bonds both fell to historic lows of 5.65 per cent and 4.8 per cent, respectively. In Japan, long-term interest rates fell to 1.5 per cent in early June 1998, down from 1.9 per cent in January.

The dollar appreciated against the deutsche mark from mid-1996 to the summer of 1997; since then the exchange rate has been rather volatile without, however, attaining its peak in 1997. Temporary selling pressures on the dollar have reflected, *inter alia,* expectations of rising German interest rates against the background of a strengthening cyclical recovery in the first quarter of 1998 and a perception that Germany (and other west European countries) might be less affected than the United States from the negative repercussions of the persisting Asian crisis.

The marked appreciation of the pound sterling against the deutsche mark has not continued in early 1998: the pound depreciated somewhat in April and May although it regained some strength in the wake of the decision of the United Kingdom monetary authorities to raise official interest rates in early June.

(iv) The short-term outlook

Economic forecasts prepared in the spring pointed to a rather favourable development in western Europe and North America in 1998 and 1999. In western Europe, the dominant expectations are still for a steady, albeit moderate, strengthening of cyclical forces; the current forecasts still point to an average annual growth of GDP in western Europe of 2¾ per cent, but this may now be an upper estimate (table 1.1.3). In contrast, in the United States the often anticipated cyclical slowdown ("soft landing") has yet to appear but is still expected to

TABLE 1.1.3

Real GDP in the ECE market economies, 1995-1998
(Percentage change over previous year)

	1995	*1996*	*1997*	*1998[a]*
Western Europe	2.7	2.0	2.7	2.8
European Union	2.5	1.7	2.6	2.8
4 major countries	2.3	1.4	2.3	2.5
France	2.1	1.6	2.3	3.0
Germany	1.8	1.4	2.2	2.6
Italy	2.9	0.7	1.5	2.5
United Kingdom	2.7	2.2	3.3	1.9
17 smaller countries	3.3	3.0	3.6	3.5
Austria	2.1	1.6	2.5	2.7
Belgium	2.1	1.5	2.9	2.5
Cyprus	5.5	1.9	2.4	4.0
Denmark	3.1	3.5	3.4	2.5
Finland	5.1	3.6	5.9	4.0
Greece	2.1	2.7	3.5	3.0
Iceland	1.1	5.5	5.0	4.6
Ireland	10.4	7.7	10.5	7.5
Israel	6.4	4.5	1.9	2.5
Luxembourg	3.8	3.0	3.7	3.4
Malta	7.3	4.2	2.8	..
Netherlands	2.3	3.3	3.4	3.8
Norway	4.1	5.5	3.4	4.6
Portugal	1.9	3.0	3.5	3.8
Spain	2.7	2.3	3.4	3.5
Sweden	3.9	1.3	1.8	2.9
Switzerland	0.8	-0.2	1.1	2.0
Turkey	7.2	7.0	6.3	4.5
North America	2.0	2.6	3.8	2.7
Canada	2.2	1.2	3.7	3.0
United States	2.0	2.8	3.8	2.7
Total above	2.3	2.3	3.3	2.8
Memorandum item:				
Japan	1.5	3.9	0.9	-0.5
Total above, *including Japan*	2.2	2.6	2.9	2.3

Source: National statistics; *OECD National Accounts* (Paris), various issues.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

[a] Forecasts.

occur eventually; current forecasts for annual growth in the United States economy in 1998 are in general close to 3 per cent but given the likelihood of a stronger than expected slowdown in export growth, the outcome could be nearer 2.7 per cent. It was clear that these benign changes depended to a large degree on how serious the ramifications of the 1997 crisis in Asia would be[5] and on the persistence of low inflationary expectations in the United States.

The economic crisis in East Asia, however, has deepened significantly in the first half of 1998. In the emerging economies of the region, the decline in output or the slowdown in economic growth, which is now forecast for 1998, is much larger than expected earlier.[6] The east Asian crisis has also acquired a much larger dimension with the deep recession in Japan against the background of a persistent crisis in the banking sector. The recession in Japan, if not quickly reversed, will aggravate the economic crisis in the east Asian emerging markets and delay their recovery. In combination, these developments will also affect growth prospects in other parts of the world economy, notably the United States. Import demand in East Asia will be lower than expected as a result of depressed domestic demand, while the pressures to step up exports to other regions of the world economy will be accentuated. The adverse changes in export demand facing the western market economies will be aggravated by the marked weakness of international raw materials prices, notably of crude oil, as witnessed recently. This, in addition to the shortfall of demand from Asia, will depress the export revenues and domestic incomes of commodity exporting countries and, consequently, their demand for products from the rest of the world.

The upshot is that the contribution to growth of the real net foreign balance in North America and western Europe in 1998-1999 is likely to be smaller (or the negative impact to be larger) than expected earlier this year, with concomitant negative repercussions on the strength of domestic demand. In other words, the downside risks to the short-term economic outlook for the western market economies have increased during the last few months.

In the United States, the available data suggest that relatively strong growth continued in the second quarter, but the expansion is now only supported by the growth of domestic demand. Changes in real net exports are expected to exert a significant drag on domestic activity levels in the second half of 1998 reflecting the strong dollar and the trade effects of the Asian crisis. In addition, stockbuilding is unlikely to continue to support economic growth. Moreover, the growth of employment, which has been supporting aggregate income growth, cannot possibly continue for much longer without rekindling inflationary pressures, given the already very low unemployment rate. Thus, even without a tightening of monetary policy there is likely to be a more or less strong slowdown in the pace of economic expansion in the second half of 1998.

A pronounced slowdown in output growth, however, could lead firms to revise downwards their profit expectations and, consequently, their investment expenditures. This will have negative ramifications not only for stock market prices but also for the situation in the labour market and the income prospects of private households. As was pointed out in the previous issue of this *Survey*,[7] household debt has risen to very high levels in the current expansion and any deterioration in the financial position of households is therefore likely to have a significant dampening impact on consumption expenditures and the growth of GDP unless offset by increases in government consumption or foreign demand.

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[5] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, p. 3.

[6] IMF, *World Economic Outlook* (Washington, D.C.), May 1998.

[7] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, p. 5.

In western Europe, the cyclical momentum associated with the strengthening of intraregional trade has so far helped to offset the negative effects of the Asian crisis. Long-term interest rates are close to historic lows, and fiscal policy has shifted to a broadly neutral stance. But net export growth will be affected by the deepening crisis in East Asia and by a slowdown in economic activity in North America and in developing countries outside Asia.

But there are also downside risks originating within western Europe. In the United Kingdom, the recent additional tightening of monetary policy has probably increased the risk of a "hard landing". It is difficult to gauge the contractionary effects of the earlier moves to tighten monetary policy, which are still "in the pipeline". Economic policy makers in the United Kingdom are currently facing the problem of a "dual economy", characterized by a general stagnation of manufacturing activity and a still buoyant private services sector. The recent large rise in the inflation rate to above 4 per cent, together with strong growth in average earnings against the background of a relatively tight labour market could well trigger a wage-price spiral. The strong pound and the slump in East Asia have started to hold back export growth. A weaker than expected growth of domestic demand in the United Kingdom would then have negative repercussions for the other west European economies as well.

The concerted and massive intervention of the United States Federal Reserve and the Bank of Japan in the foreign exchange markets on 17 June 1998 has led to a substantial strengthening of the yen. The spot exchange rate against the dollar fell to about 137 yen, compared with an eight-year high of some 144 yen on the previous day. But the current relative stability in financial markets could well be short-lived if expectations of a significant policy shift in Japan are not being confirmed and strengthened in the near future. There still appear to be lingering doubts as to whether the latest economic stimulus package adopted in April 1998 is sufficient to trigger a sustained recovery. Overall, the confidence of the population in the effectiveness of such measures appears to have been eroded over time. Income tax cuts may be less effective in an environment where the spending propensity of households has been dampened by the steady deterioration in the labour market and concerns over the stability of the banking sector. Any fiscal stimulus, to be effective, will probably have to focus on a large increase in direct government expenditures and be accompanied by a comprehensive and credible package of financial sector reform and a more resolute handling of the bad loan problem of the banks.

The other fundamental problem remains the large interest rates differential between dollar and yen denominated financial assets, which will continue to put selling pressure on the yen. The dilemma is that their diverging cyclical positions do not provide any scope for either the Japanese or the United States monetary authorities to reduce this margin. The support provided to the yen mainly reflected concerns about the stability of the exchange rate pattern in the Asian region, notably the ability of China to maintain the exchange rate peg against the dollar in the face of more sluggish export growth, weakening domestic demand, and indications of fragility of the banking sector. These basic problems facing China, however, have not been fundamentally changed by the recent partial reversal of the yen depreciation. It goes without saying that any new exchange rate crisis in East Asia would have significant spillover effects for the rest of the world economy as well.

1.2 The transition economies

(i) The economic pattern in the first half of 1998

(a) The general context

For the transition economies taken as a whole, 1997 was probably the best year since 1989. Subsequent revisions of the annual GDP data point to a somewhat better growth performance than was implied by the preliminary estimates for 1997, especially as regards the CIS as a whole (tables 1.2.1 and 1.2.2).[8] The revised figures indicate that the aggregate GDP of all the transition economies grew by just under 2 per cent in 1997, that of the Commonwealth of Independent States increasing by 1 per cent.

The positive trends which prevailed in most of these countries in the second half of 1997 have been maintained during the early months of 1998.[9] Preliminary data for the first quarter suggest that output continued to rise in the transition countries as a whole and in all the main subregions as well (table 1.2.3). The performance of individual countries remains quite heterogeneous, but there appears to be less variation among them in 1998 as compared with previous years.

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[8] Since the publication of the UN/ECE, *Economic Survey of Europe, 1998 No. 1*, in April, a number of national statistical offices in the transition countries have revised their previous estimates for some of the economic indicators for 1997. In terms of its impact on aggregate performance, the most important change was the upward revision of the GDP growth rate for Russia from 0.4 per cent to 0.8 per cent (mainly due to a change in methodology). GDP growth for all the Baltic states and Hungary have also been revised upwards, but for the Czech Republic it was lowered. Tables 1.2.1 and 1.2.2 contain the revised and updated 1997 data that were available to the ECE secretariat in mid-June.

[9] It should be noted that this mid-year review can only present a rough assessment of the current economic situation in the transition countries as it is based on preliminary (monthly and quarterly) statistics prepared by the national statistical offices. Some of the short-term economic indicators often differ in methodology and coverage from the annual figures based on national accounts. Due to the lags in statistical reporting, virtually no detailed quarterly national accounts for 1998 were available for the transition countries at the time of writing this *Survey*.

TABLE 1.2.1

Basic economic indicators for the ECE transition economies, 1995-1998

(Rates of change and shares, per cent)

	GDP (growth rates)					*Industrial output (growth rates)*			*Inflation (per cent change, Dec./Dec.)*			*Unemployment rate (end of period, per cent)*		
			1997											
	1995	*1996*	*Ex-ante forecast*	*Actual outcome*	*1998 forecast*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	6.1	4.1	3.5	2.9	4¼	7.7	6.5	5.6	..	..	..	12.5	11.8	11.7
Albania	13.3	9.1	..	-7	10	-7.2	13.6	-5.6	6.0	17.4	42.0	13.1	12.1	14.9
Bosnia and Herzegovina [a]	..	..	..	..	..	60.8	87.3	35.1	-34.2	3.2	12.2	..	..	..
Bulgaria	2.9	-10.1	-(2-4)	-6.9	3	4.5	3.8[b]	-7.0	33.0	311.1	578.7	11.1	12.5	13.7
Croatia	6.8	6.0	5.5	6.5	7.5	0.3	3.1	6.8	3.7	3.5	4.0	17.6	15.9	17.6
Czech Republic	6.4	3.9	4-5	1.0	1.4-2.6	8.7	| 2.0	4.5	7.9	8.7	9.9	2.9	3.5	5.2
Hungary	1.5	1.3	2	4.4	4	4.5	3.4	11.1	28.5	20.0	18.4	10.4	10.5	10.4
Poland	7.0	6.1	5-6	6.9	5.6-5.8	9.7	8.3	10.8	22.0	18.7	13.2	14.9	13.2	10.5
Romania	7.1	3.9	-2	-6.6	–	9.4	9.9	-5.9	27.7	56.8	151.7	9.5	6.6	8.8
Slovakia	6.9	6.6	6	6.5	5	8.3	2.4	2.7	7.4	5.5	6.5	13.1	12.8	12.5
Slovenia	4.1	3.1	4	3.8	3.5-4	2.0	1.0	1.0	9.0	9.0	8.8	14.5	14.4	14.8
The former Yugoslav Republic of Macedonia	-1.2	0.7	..	1.0	5	-10.7	3.1	1.6	11.2	0.3	4.5	37.2	39.8	42.5
Yugoslavia [c]	6.1	5.9	13	7.4	10	3.8	7.5	9.5	110.7	59.9	10.3	24.7	26.1	25.6
Baltic states	2.3	4.1	4.5	7.4	6½	1.3	4.8	5.6	..	..	..	6.5	6.4	6.3
Estonia	4.3	4.0	4-5	11.4	5.5-6	1.9	3.4	13.4	28.8	15.0	12.3	5.0	5.6	4.6
Latvia	-0.8	3.3	3.5	6.5	5-6	-3.7	5.5	6.1	23.3	13.2	7.0	6.6	7.2	6.7
Lithuania	3.3	4.7	5	5.7	7	5.3	5.1	0.3	35.5	13.1	8.5	7.3	6.2	6.7
CIS	-5.5	-3.4	..	1.0	1¼	-5.9	-2.8	2.3	..	..	..	5.8	6.2	6.2
Armenia	6.9	5.8	..	3.1	5-6	1.5	1.2	0.9	32.0	5.6	21.8	8.1	9.7	11.0
Azerbaijan	-11.8	1.3	..	5.8	..	-17.2	-6.7	0.3	84.5	6.8	0.3	1.1	1.1	1.3
Belarus	-10.4	2.8	5	10.4	7-8	-11.7	3.5	17.6	244.2	39.1	63.4	2.7	4.0	2.8
Georgia	2.6	8.6	..	11.3	11-13	-9.8	7.7	8.1	57.4	13.6	7.3	3.4	3.2	2.6
Kazakhstan	-8.2	0.5	2	2.0	3.5	-8.2	0.3	4.0	60.4	28.6	11.3	2.1	4.1	3.9
Kyrgyzstan	-5.4	7.1	..	10.4	3.6	-17.8	8.8	46.8	31.9	35.0	14.7	3.0	4.5	3.1
Republic of Moldova [d]	-1.9	-7.8	5-7	1.3	3-3.5	-3.9	-6.5	-2.3	23.8	15.1	11.1	1.4	1.5	1.7
Russian Federation	-4.1	-3.5	0-2	0.8	0-0.5	-3.3	-4.0	1.9	131.4	21.8	11.0	8.9	9.3	9.0
Tajikistan	-12.4	-16.7	..	1.7	..	-13.6	-23.9	-2.5	2 382.2	40.6	159.9	1.8	2.4	2.8
Turkmenistan	-7.7	0.1	..	-20*	..	-6.4	17.9	-35*	..	..	..	..	..	..
Ukraine	-12.2	-10.0	..	-3.0	0.5	-12.0	-5.1	-1.8	181.7	39.7	10.1	0.6	1.5	2.8
Uzbekistan	-0.9	1.7	..	5.2	6	0.1	6.0	6.5	..	..	..	0.3	0.3	0.3
Total above	-1.3	-0.4	..	1.9	2½	-1.7	0.4	3.5	..	..	..	7.5	7.8	7.8
Memorandum items:														
CETE-5	6.0	5.0	4.5	5.5	4.7	8.5	6.1	8.9	..	..	..	12.0	11.3	9.9
SETE-7	6.2	2.1	..	-2.9	3.3	5.8	7.6	-2.6	..	..	..	13.7	12.8	14.2
Ex-GDR Länder	5.2	1.9	1.0	1.6	..	5.8	4.3	5.0	..	..	..	..	..	..

Source: National statistics, CIS Statistical Committee and direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

Note: Aggregates are UN/ECE secretariat computations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation where it is the Goskomstat estimate according to ILO definition and Estonia where it refers to job seekers). Aggregates shown are: *Eastern Europe* (the 12 countries below that line), with sub-aggregates *CETE-5* (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and *SETE-7* (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia); *Baltic states* (Estonia, Latvia, Lithuania); *CIS* (12 member countries of the Commonwealth of Independent States); and *total transition countries.*

[a] Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

[b] Bulgarian industrial output indices were recently recalculated according to a new methodology and old series reportedly have been revised back to 1991. Here and in appendix table B.4 the industrial output indices now cover gross output of all activities of industrial enterprises (and not gross output of "pure" industry, as previously published). The figure for industrial output growth in 1996 according to the new methodology (3.8 per cent) differs significantly from the figure for the rate of change of gross industrial output (-9.1 per cent) reported in the national accounts for the same year.

[c] Gross material product instead of GDP.

[d] Excluding Transnistria.

TABLE 1.2.2

International trade and external balances of the ECE transition economies, 1995-1997

(Rates of change and shares, per cent)

	Merchandise exports in dollars (growth rates)			*Merchandise imports in dollars (growth rates)*			*Trade balances (per cent of GDP)*			*Current account (per cent of GDP)*		
	1995	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	27.8	2.3	5.9	32.2	14.3	6.1	-6.3	-9.5	-10.1	-0.3	-3.8	-4.2
Albania	45.5	5.3	-35.6	18.4	40.5	-32.1	-18.2	-26.0	-20.7	-0.6	-4.0	-11.6
Bosnia and Herzegovina	..	144.7	87.4	..	129.9	29.2	..	..	..	..	..	..
Bulgaria	35.8	-8.5	0.5	32.0	-10.0	-3.7	-2.2	-1.9	0.3	-0.2	0.2	4.4
Croatia	8.7	-2.6	-7.6	43.6	3.7	16.9	-15.3	-16.6	-25.3	-6.8	-4.5	-11.7
Czech Republic	33.6	1.2	2.8	45.0	9.7	-2.7	-7.1	-10.3	-8.5	-2.7	-7.6	-6.1
Hungary	20.2	2.2	21.4	6.3	4.8	16.3	-5.8	-5.4	-4.5	-5.6	-3.7	-2.2
Poland	32.8	6.8	5.4	34.7	27.9	13.9	-5.2	-9.4	-12.2	4.6	-1.0	-3.1
Romania	28.6	2.2	4.3	44.6	11.3	-1.4	-6.7	-9.5	-8.2	-5.0	-7.3	-7.2
Slovakia	27.9	2.8	0.2	32.3	26.6	-8.0	-1.1	-12.2	-7.1	3.7	-11.2	-6.9
Slovenia	21.8	-0.1	0.8	30.0	-0.7	-0.7	-6.3	-5.9	-5.5	-0.1	0.2	0.4
The former Yugoslav Republic of Macedonia	10.8	-4.7	4.7	15.8	-5.4	7.0	-12.8	-12.2	-16.3	-5.5	-7.3	-8.3
Yugoslavia	..	20.6	28.7	..	54.3	16.7	-12.2	-14.2	-13.4	..	..	..
Baltic states	35.2	17.7	22.8	41.6	26.3	26.5	-15.4	-18.6	-22.0	-5.8	-8.2	-10.3
Estonia	40.6	13.2	40.1	53.0	27.3	36.7	-19.8	-26.5	-32.1	-5.2	-9.7	-13.0
Latvia	31.9	10.7	15.8	46.6	27.6	17.4	-11.5	-17.1	-19.0	-0.4	-5.4	-8.0
Lithuania	33.3	24.0	15.1	31.0	24.9	23.8	-15.7	-15.3	-18.7	-10.2	-9.2	-10.3
CIS	32.7	10.3	1.6	24.3	6.1	17.8	7.3	6.9	5.2	1.6	1.6	-0.5
Armenia	74.1	60.6	-15.0	80.9	70.0	2.6	-18.6	-26.1	-29.0	-21.7	-18.3	-19.4
Azerbaijan	-7.0	-3.1	18.1	50.3	41.4	-28.6	-3.6	-8.8	-1.0	-16.6	-29.2	-23.8
Belarus	72.2	6.3	1.8	93.5	25.6	20.7	-1.1	-3.5	-7.1	-5.5	-3.8	-6.1
Georgia	48.7	21.2	60.7	254.7	79.5	42.2	-6.1	-8.2	-9.7	-7.6	-6.6	-7.0
Kazakhstan	74.4	15.7	28.4	-16.6	12.3	51.9	7.3	6.9	6.9	-3.1	-3.6	-4.3
Kyrgyzstan	19.7	-20.0	154.5	56.5	107.6	-21.9	-1.9	-13.4	0.6	-15.6	-23.6	-7.8
Republic of Moldova	74.4	-8.4	5.7	48.5	52.7	37.3	0.5	-9.6	-16.0	-6.7	-11.3	-15.8
Russian Federation	29.4	8.8	-1.6	16.8	-4.9	22.4	8.5	8.6	6.4	3.0	3.3	0.6
Tajikistan	24.4	-11.6	7.7	5.7	-13.9	-7.9	35.3	14.6	22.7	0.2	-10.5	..
Turkmenistan	92.5	-42.1	-45.5	-20.8	49.3	-42.5	9.0	-20.3	..	-1.1	0.1	..
Ukraine	32.6	13.0	24.0	88.7	18.8	11.2	1.8	1.0	2.8	-3.1	-2.7	-2.7
Uzbekistan	77.2	94.0	-3.6	35.6	96.0	0.2	0.8	0.9	–	-0.5	-7.8	-3.4
Total above	30.1	6.3	4.6	30.3	12.7	10.1	1.2	0.1	-1.1	0.7	-0.6	-2.0
Memorandum items:												
CETE-5	28.8	3.1	6.8	30.5	15.4	6.2	-5.5	-8.9	-9.4	0.9	-3.4	-3.6
SETE-7	23.9	-0.6	2.6	38.4	8.7	4.8	-8.9	-11.3	-12.5	-4.6	-5.4	-6.8

Source: UN/ECE secretariat computations based on national statistics and direct communications from national statistical offices.

Note: Foreign trade growth is measured on current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Trade values include the "new trade" among the successor states of former Czechoslovakia and the former SFR of Yugoslavia, but not intra-CIS trade. Current account data for Russia refer to relations with the "far abroad" (non-CIS countries) only, whereas those for other CIS countries cover all external relations (non-CIS and CIS). Current-price GDP values for Albania and Armenia are estimated from reported real growth rates and consumer price indices. On regional aggregates, see note to table 1.2.1.

Favourable demand conditions in western Europe have contributed to the continuing strength of economic performance in eastern Europe and in the Baltic region: total exports from these countries continued to rise strongly in the first quarter of the year. Rates of inflation continued to fall in most transition countries and there has been some improvement (or at least no further deterioration) in the external balances of some east European countries. However, the fall in world commodity prices in 1998 has had a negative impact on the export earnings of Russia and other CIS primary commodity exporters.[10]

Although on balance developments have remained positive in the first half of the year, economic performance in some countries has remained bleak and in others has been marked by considerable volatility. The most serious disturbance occurred in Russia which was shaken by financial instability in May-June (see section 1.2(ii)). The shockwaves of this sudden turbulence were felt on all financial markets in central and eastern Europe and in the Baltic region. Neighbouring Belarus was also hit by financial turmoil in March-April leading to a sharp drop in the exchange rate of the national currency. Economic performance in most of the south-east European transition countries has remained rather weak.

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[10] In April 1998, copper, aluminium, nickel, zinc and lead prices were lower by 21, 11, 22, 17 and 8 per cent respectively compared with their 1997 averages. Also, the oil price was hovering around $13.5 a barrel in April compared with an average price of $19.3 in 1997 – a decline of 30 per cent. IMF, *Primary Commodity Prices* (http://www.imf.org/external/np/res/commod/index.htm).

TABLE 1.2.3

GDP and industrial output in the ECE transition economies, 1997-1998

(Percentage change over the same period of the preceding year)

	GDP					*Industrial output*				
	1997				*1998*	*1997*				*1998*
	Jan.-Mar.	*Jan.-Jun.*	*Jan.-Sept.*	*Jan.-Dec.*	*Jan.-Mar.*	*Jan.-Mar.*	*Jan.-Jun.*	*Jan.-Sept.*	*Jan.-Dec.*	*Jan.-Mar.*
Eastern Europe	..	..	..	2.9	..	5.2	6.1	5.5	5.6	6.8
Albania	..	..	..	-7	..	..	..	..	-5.6	-13.8
Bosnia and Herzegovina	..	..	..	..	..	52.9	44.8	36.9	35.1	14.3
Bulgaria	-21.0	-18.0	-10.7	-6.9	..	..	..	..	-7.0	6.2
Croatia	4.6	5.3	6.3	6.5	3.2	2.8	4.8	5.3	6.8	6.4
Czech Republic	1.2	0.9	0.5	1.0	-0.9	-2.7	1.3	2.7	4.5	8.4
Hungary	2.1	3.2	3.9	4.4	5	5.5	7.9	9.6	11.1	13.6
Poland	7.0	7.3	7.1	6.9	6.5	7.4	10.7	11.1	10.8	11.0
Romania	..	..	..	-6.6	..	12.5	2.8	-3.5	-5.9	-14.9[a]
Slovakia	6.4	6.3	6.4	6.5	6.2	1.7	3.5	2.4	2.7	4.7
Slovenia	3.2	4.3	3.9	3.8	6.5	-2.4	0.9	0.9	1.0	10.1
The former Yugoslav Republic of Macedonia	..	..	..	1.0	..	7.0	3.3	2.5	1.6	9.1
Yugoslavia	..	..	..	7.4	..	6.6	7.7	8.5	9.5	15.1
Baltic states	..	..	..	7.4	..	-1.4	4.0	4.2	5.6	8.9
Estonia	8.2	10.1	10.6	11.4	8	9.3	12.7	12.3	13.4	11.3
Latvia	3.0	5.1	6.3	6.5	..	-4.3	1.0	3.0	6.1	13.7
Lithuania	4.1	7.1	6.1	5.7	6	-5.8	0.8	-0.1	0.3	3.0
CIS	..	..	..	1.0	..	–	0.6	1.8	2.3	2.9
Armenia	1.4	1.4	2.5	3.1	6.4	-2.8	-2.9	0.1	0.9	4.4
Azerbaijan	3.5	5.2	5.0	5.8	8.2	0.4	0.2	0.2	0.3	0.2
Belarus	9.0	11.0	10.5	10.4	13	9.8	13.9	15.8	17.6	14.6
Georgia	8.9	14.7	11.3	11.3	11.2	10.9	11.8	11.9	8.1	-3.2
Kazakhstan	0.5	1.6	2.2	2.0	1.9	1.2	2.8	3.6	4.0	3.8
Kyrgyzstan	0.1	6.8	19.2	10.4	11.5	6.9	28.8	45.9	46.8	52.1
Republic of Moldova	-5.5	-4.3	-0.5	1.3	..	-14.9	-11.7	-5.5	-2.3	3.4
Russian Federation	0.3	-0.2	0.2	0.8	–	0.7	0.8	1.4	1.9	1.2
Tajikistan	4.8	5.5	2.0	1.7	1.3	-14.5	-9.9	-8.0	-2.5	9.5
Turkmenistan	..	..	..	-20*	..	-14.7	-35.2	..	-35*	-11
Ukraine	-7.9	-7.5	-5.0	-3.0	-0.2	-6.0	-4.5	-2.4	-1.8	1.7
Uzbekistan	1.7	3.9	4.9	5.2	3.3	4.2	5.4	6.0	6.5	4.3
Total above	..	..	..	1.9	..	1.7	2.6	3.1	3.5	4.0
Memorandum items:										
CETE-5	..	..	..	5.5	..	5.0	8.2	8.7	8.9	10.5
SETE-7	..	..	..	-2.9	..	5.7	0.8	-2.4	-2.6	-3.4
Ex-GDR Länder	..	..	..	1.6	..	..	..	..	5.0	..

Source: National statistics, CIS Statistical Committee and direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

Note: Industrial output figures in table 1.2.3 are based on monthly statistical reporting. Because of differences in coverage, monthly cumulative figures for 1997 as a whole differ slightly from reported annual figures for some countries. For these countries reported annual figures have been used. On regional aggregates see the note to table 1.2.1.

[a] January-February.

Political cycles seem to be gaining importance in terms of their impact on the economic environment in the transition economies. In the Czech Republic, Hungary, the Republic of Moldova and Ukraine 1998 is an election year, and both pre- and post-election hesitance of investors about the future course of economic policy has been affecting financial markets in these countries. However, the change of government in Poland after the 1997 elections has had no disturbing effect on economic performance; on the contrary, there has been a remarkably smooth continuity in the underlying course of economic policy.

One of the important policy events in early 1998 was the formal opening by the European Union of the enlargement process towards central Europe. On 31 March six applicant countries – the Czech Republic, Estonia, Hungary, Poland and Slovenia, together with Cyprus – officially started the process of pre-accession negotiations with the EU. Five other countries with association agreements with the European Union – Bulgaria, Latvia, Lithuania, Romania and Slovakia – are also formally involved in the enlargement process but substantive negotiations with them will only start at a later stage. The target of full EU membership – if pursued consistently – will set a rather rigid policy framework for the applicant countries during the pre-accession period leaving relatively limited degrees of freedom for deviations from this course. Thus, if there is a strong political commitment by policy makers both in the EU itself and in the candidate countries to accelerate the process of EU accession (as is the declared aim of practically all the influential political forces in the region), this in itself will provide another safeguard of political and economic stability – as well as of stability in the course of economic policy – in these countries.

The short-term economic outlook for the transition economies as a whole remains positive and it is likely that economic conditions in general will continue to be favourable in the second half of the year for the majority of these countries. Among the east European and Baltic countries, some further acceleration of growth can be expected in Hungary and possibly in Slovenia while the Estonian economy is likely to perform above official expectations. In contrast, economic decline is likely to continue in Romania and the output performance for the year as a whole may well turn out to be below the official zero growth target. The 10 per cent growth target in Yugoslavia for 1998 is also unlikely to be met. Within the Commonwealth of Independent States, and despite the apparent improvement from previous years, there remain many uncertainties regarding the outlook for all the European CIS countries.

However, the greatest potential risks both for the CIS and for eastern Europe as a whole arise from the considerable uncertainty surrounding the economic situation in Russia. In view of the financial instability observed in the first half of 1998 and the subsequent substantial tightening of monetary and fiscal policy, the short-term growth prospects in Russia have deteriorated considerably. Official forecasts were already being revised downwards in the first quarter (table 1.2.1), but if instability and policy austerity continue, Russian GDP growth in 1998 may very well fall below these revised targets, and in the second half of the year there could even be a fall in aggregate output. As discussed below in section 1.2(ii), the biggest policy challenge facing the Russian authorities at this point is how to restore financial stability and get the economy onto a path of sustained growth.

(b) Output and demand

Judging by the data for industrial output (table 1.2.3), economic activity in the first months of 1998 was buoyant in most of the *central European countries* and in the *Baltic states*.

First quarter data indicate a further acceleration of industrial output growth in Hungary to a double-digit rate (manufacturing output alone grew by almost 20 per cent year-on-year in the first quarter). The expansion of manufacturing industry – which is the main factor behind the Hungarian economic recovery – is being driven in the first place by steady export growth: sales of manufactured products abroad in the first quarter of 1998 were 37 per cent higher than a year earlier.[11] Although the official Hungarian forecasts for 1998 have not been revised, it is generally expected that GDP will rise by more than the 4 per cent envisaged in the budget forecast.[12] Consumer demand in Hungary has been recovering more slowly: in 1997, private consumption was still shrinking, but this decline appears to have come to an end and the volume of retail sales in the first quarter of 1998 was starting to grow, albeit at a modest rate (table 1.2.4).

TABLE 1.2.4

Retail trade in the transition economies, 1996-1998

(Percentage change over same period of previous year)

		1997				*1998*
	1996	*Jan.-Mar.*	*Jan.-Jun.*	*Jan.-Sept.*	*Jan.-Dec.*	*Jan.-Mar.*
Bulgaria	0.5	-42.7	-39.7	-36.6	-33.0	6.3
Croatia	3.4	28.8	5.9	5.6	14.9	2.5
Czech Republic	12.1	2.4	3.5	1.4	1.9	-4.9
Hungary	-5.0	-8.8	-4.9	-1.8	-1.0	–
Poland	4.5	11.6	13.3	13.8	15.0	15.0
Romania	15.3	-19.5	-28.5	-28.4	-26.8	-3.6
Slovakia	6.9	6.8	4.3	4.6	4.6	7.3
Slovenia	14.1	5.8	8.0	8.9	1.0	7.1
The former Yugoslav Republic of Macedonia	-10.2	-8.4	-3.0	1.2	4.2	3.8
Yugoslavia	8.0	10.0	2.0	9.0	9.0	12.5
Estonia	2.0	11.0	11.5	14.0	15.8	4.5
Latvia	-9.0	6.6	9.1	14.1	14.2	16.3
Lithuania	5.0	..	16.7	15.3	13.4	18.9
Armenia	12.5	4.0	4.0	5.0	5.2	2
Azerbaijan	14.1	25.0	21.0	18.0	17.3	12
Belarus	30.5	26.0	20.0	19.0	19.6	44
Georgia	22.5	58.0	24.0	29.0	27.5	20
Kazakhstan	33.3	31.0	30.0	26.0	23.1	31
Kyrgyzstan	1.8	7.0	4.0	8.0	8.6	12
Republic of Moldova[a]	-5.0	-4.0	-6.0	-6.0	-5.4	-13
Russian Federation	-4.0	0.4	0.7	0.7	2.5	4
Tajikistan	-0.9	69.0	90.0	38.0	8.0	-36
Turkmenistan	-32.3	..	..	..	..	9
Ukraine[a]	-5.1	-0.2	3.0	5.0	4.2	-2
Uzbekistan	22.2	2.0	14.0	10.0	12.7	17

Source: National statistics, CIS Statistical Committee and direct communications from national statistical offices to UN/ECE secretariat.

Note: Retail trade covers goods and catering in Hungary and the CIS countries; mainly goods in Bulgaria, the Czech Republic, Croatia, Poland, Romania, Slovakia, Slovenia, The former Yugoslavia Republic of Macedonia, Yugoslavia and the Baltic states. The coverage in 1997 and 1998, based on current reporting, may differ from the coverage in the annual statistics.

[a] Registered enterprises (for the Ukraine, 1994-1996).

The Polish economy has continued to grow strongly, boosted by booming industrial output and continuing growth in domestic demand (table 1.2.4). Indeed, the Polish authorities are now facing a policy dilemma of how to cope with two simultaneous developments which present potential threats to macroeconomic stability: namely, the overheating of the economy and a strong inflow of foreign capital. As monetary policy alone cannot efficiently address these two developments at the same time,[13] some further fiscal austerity may be needed to dampen inflationary pressures before they present a possible danger to overall economic stability.

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[11] Hungarian Central Statistical Office, *Monthly Bulletin of Industry*, performance of industry in March 1998 (internet edition: http://www.ksh.hu/eng/bulle.html).

[12] According to the Deputy Governor of the National Bank of Hungary, Gyorgy Szapary, GDP growth of 5 per cent or more might be possible in 1998. Reuters News Service, 12 May 1998.

Output has also continued to grow strongly in the three Baltic states. After rising by more than 11 per cent in 1997, GDP growth in Estonia decelerated somewhat during the first quarter of 1998 but it still remained quite high (8 per cent) and the annual figure is likely to exceed the previous official forecast of 6 per cent.[14] In both Latvia and Lithuania, the data for the first quarter point to a further acceleration of economic growth (table 1.2.3).

The austerity measures introduced in 1997 and aimed at restoring equilibrium in the Czech economy led to a sharp contraction of domestic demand which has become even more pronounced in 1998: the volume of retail sales fell by some 5 per cent (year-on-year) in the first quarter (table 1.2.4). Nevertheless, there has been a notable improvement in industrial output performance (table 1.2.3). The main factors behind this acceleration were increased competitiveness and a rapid growth of exports, both positive outcomes of the policy adjustment measures.

After several years of sluggish growth, industrial output in Slovenia picked up very strongly in the first quarter of 1998 (1.2.3), fostered by rapid export growth (table 1.2.8). If this turns out to be more than a seasonal fluctuation, it may result in an acceleration of economic growth in Slovenia in 1998. Relatively strong growth has also continued in Slovakia and Croatia in the first half of 1998, although some moderation can probably be expected in the second half as there has been some tightening of policy in recent months in response to the large external imbalances which both countries are facing (table 1.2.2).

In contrast to central Europe and the Baltic region, the economic situation in most of the transition economies of *south-east Europe* has remained rather bleak in the first half of 1998. After the devastating economic crisis which hit Bulgaria in 1996-1997, there was a modest upturn in the first quarter of 1998. Since the introduction of a currency board in mid-1997 there has been significant progress in bringing down the inflation rate and restoring financial stability; however, the strength of the output recovery so far has fallen below expectations. The economic and political crisis in Romania (which resulted in a change of government in April) had still not come to a definite end at the moment of writing this *Survey*. Output continued to decline sharply in the first quarter of 1998 (table 1.2.3) and there was also a further drop in the volume of retail trade after the considerable fall in demand which occurred in 1997 (table 1.2.4). The zero growth target incorporated in the 1998 budget (which was only voted on 26 May) may thus appear to be somewhat optimistic.

In the first months of 1998 there was an outburst of economic instability in Yugoslavia. On 31 March, the Yugoslav authorities, faced with growing macroeconomic imbalances,[15] announced a devaluation of the dinar from 3.3 to 6 dinar/DM. Following the devaluation, there was a sharp fall in industrial output in April (which had been growing rapidly in the first quarter – table 1.2.3) coupled with an inflationary upsurge. Due to the political unrest in Kosovo, Yugoslavia is facing increased financial isolation and the threat of renewed economic sanctions. Given these negative developments, the actual outcome for the year as a whole is likely to fall well below the official target for GDP growth of 10 per cent in 1998.

In early 1998, there was some acceleration of output growth (or, in a few cases, a slower rate of decline) in the majority of *CIS countries,* although the reliability of the statistical data for some of them remains questionable. However, there still remain considerable uncertainties about the course of economic reforms in many of the CIS countries, and therefore about the prospects for a sustained recovery. Thus, after a relatively successful performance in 1997 (positive GDP growth for the first time since 1989), the economic situation deteriorated during the first quarter of 1998: GDP was no higher than a year earlier and the growth of industrial output slowed down. The dangerous escalation of financial instability in May (discussed in more detail in section 1.2(ii)) provoked a severe tightening of monetary and fiscal policies. The adherence to macroeconomic austerity and stringent policies, measures required to preserve financial stability, is likely to have a further negative impact on output in the second half of the year.

There are still serious concerns about the economic situation in neighbouring Ukraine, Belarus and, to some extent, the Republic of Moldova. Although the measured GDP decline in Ukraine was apparently coming to a halt in the first half of the year (industrial output even increased in the first quarter – table 1.2.3), the macroeconomic stance remains very fragile. Ukraine is facing considerable fiscal imbalances and a shortage of financial resources. At the same time, political disputes following the parliamentary elections (which failed to produce a dominant reformist political power) have caused delays in the adoption of important legislation and in the negotiations with the IMF. In addition, a wave of strikes swept through the country in the first half of 1998 and a spillover of instability from Russia put pressure on the Ukrainian financial markets in May. It remains to be seen whether, and to what extent, the authorities will be able to keep the economy on track towards economic stability and recovery.

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[13] For example, monetary austerity and rising interest rates might dampen final demand but they might also stimulate even larger capital inflows.

[14] At the time of writing, the Estonian authorities were considering an upward revision of the growth target for 1998. Baltic Business Daily, Baltic News Service, 2 June 1998.

[15] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, p. 90.

Despite a reported double-digit rate of economic growth in the first quarter of 1998 (seemingly the highest among all the transition economies), there was a serious exchange rate crisis in Belarus in this period. The run on the currency in March-April resulted in a large depreciation of the Belarus rouble and caused a major disturbance on the domestic financial markets. The currency crisis was the outcome of a loose and imprudent monetary policy: large amounts of administratively allocated credit were pumped into the economy and, apart from engineering the reported high rates of output growth, these resulted in an uncontrolled monetary expansion, a weakening of the currency, and a high rate of inflation. In turn, the post-crisis attempts of the Belarusian authorities to impose administrative control over prices has led to the re-emergence of shortages, reminiscent of the centrally planned economy.

The situation in the Republic of Moldova also remains precarious. Economic performance has been sluggish and large fiscal and current account deficits have continued for some time (tables 1.2.1 and 1.2.2); nevertheless, much needed policy changes were suspended in the wake of the March 1998 elections. The new government is now facing the challenge of having to introduce some harsh policy adjustments in order to restore macroeconomic equilibrium.

Output continued to grow in the first half of 1998 in most of the other CIS countries where, in general, governments are quite optimistic about their short-term economic prospects (table 1.2.1). One major exception is Turkmenistan where the economy has been severely affected by the disruption in exports of gas to other CIS countries.

(c) *Inflation*

Falling rates of inflation in 1997 and in the first months of 1998 were most pronounced in the Baltic states and in the majority of the CIS countries. In eastern Europe, inflation during 1997, measured by the consumer price index, fell only in Hungary, Poland and Yugoslavia, and more or less stabilized in Slovenia. In all the other east European countries, it accelerated.

In general, wage inflation was declining in 1997, although it was still higher than the increase in producer prices. However, thanks to a widespread improvement in labour productivity, the growth in unit labour costs slowed significantly in most countries. Import price pressures were also rather subdued in 1997, a result of weak world commodity prices and generally strong national currencies. This favourable cost performance allowed an increase in profit margins and consequently supported a marked improvement in fixed investment.

TABLE 1.2.5

Consumer prices in the transition countries, 1996-1998
(Percentage change)

	Annual average, all items		*December over previous December*		*April over previous December*	
	1996	*1997*	*1996*	*1997*	*1997*	*1998*
Albania	12.7	33.1	17.4	42.0	20.1	8.3
Bosnia and Herzegovina	-21.2	11.8	3.2	12.2	7.1	3.6
Bulgaria	123.1	1 082.6	311.1	578.7	448.4	3.7
Croatia [a]	3.6	3.7	3.5	4.0	1.2	3.3
Czech Republic	8.9	8.4	8.7	9.9	2.2	5.0
Hungary	23.6	18.4	20.0	18.4	9.5	7.2
Poland	19.8	15.1	18.7	13.2	5.9	6.2
Romania	38.8	154.9	56.8	151.7	88.7	19.9
Slovakia	6.0	6.2	5.5	6.5	2.5	3.2
Slovenia	9.9	8.4	9.0	8.8	3.7	4.0
The former Yugoslav Republic of Macedonia [a]	4.1	3.6	0.3	4.5	3.0[b]	0.8[b]
Yugoslavia	90.5	23.1	59.9	10.3	4.3	13.8
Estonia	23.2	11.1	15.0	12.3	5.1	5.3
Latvia	17.7	8.5	13.2	7.0	3.4	2.5
Lithuania	24.7	8.8	13.1	8.5	3.8	2.4
Armenia	18.7	13.8	5.6	21.8	7.3	6.1
Azerbaijan	19.8	3.6	6.8	0.3	4.5	2.8
Belarus	52.7	63.9	39.1	63.4	28.9	14.9
Georgia	39.4	6.9	13.6	7.3	3.9	2.3
Kazakhstan	39.1	17.4	28.6	11.3	5.5	4.2
Kyrgyzstan	30.3	25.5	35.0	14.7	9.8	5.7
Republic of Moldova	23.5	11.8	15.1	11.1	5.2	2.3
Russian Federation	47.8	14.7	21.8	11.0	6.3	3.4
Tajikistan	422.4	85.4	40.6	159.9	35.1	5.7
Turkmenistan	..	..	..	..	..	..
Ukraine	80.2	15.9	39.7	10.1	4.4	3.0
Uzbekistan	..	..	..	..	..	..

Source: UN/ECE secretariat estimates, based on national statistics.

[a] Retail price index. For Croatia the food price index is from the cost of living index.

[b] March over previous December.

During January-April 1998, inflationary pressures continued to weaken in the majority of the transition economies (table 1.2.5). The fall in inflation was most spectacular in Bulgaria: the cumulative four-month rate of inflation fell from nearly 450 per cent in 1997 (when Bulgaria was close to hyperinflation) to less than 4 per cent in 1998, one of the lowest rates in the region. In fact there was a virtual price stability during March-April.

The major factors behind this general lowering of inflation rates during the early months of 1998 were the continued weakness of import prices and further large gains in labour productivity in some countries, particularly in industry. World market commodity prices fell to their lowest levels for several years, due to anticipated weaker demand (in turn largely due to the Asian crisis) and the worldwide oversupply. Partial and preliminary wage data suggest that the growth in unit labour costs continued to decelerate in most of the transition countries in early 1998.

The impact of these generally favourable cost developments on the level of consumer prices was reduced because of the continuing correction of relative prices in the transition countries. For example, indirect taxes, regulated rents and utility prices were raised sharply in the Czech Republic in January and further increases are planned in July. However the acceleration of inflation in the Czech Republic during the early months of 1998 was also due to the lagged effects of the weakened exchange rate and relatively poor productivity performance during most of 1997. Nevertheless, the monthly rate of inflation slowed down considerably in March-April, and – unless the koruna weakens around the June elections – the year-end net inflation[16] target of 6.5 per cent of the Czech National Bank does not seem overoptimistic. However, inflation in Hungary might pick up if the newly elected government pursues its election promises of faster growth and lower unemployment since these would require a loosening of fiscal and monetary policies. In Poland, there are some concerns that overheating of the economy could raise the rate of inflation; the prospects for future declines in the rate may also be impaired if the authorities decide to go ahead with the potentially expensive social welfare programmes proposed by some members of the new government.

(d) Labour markets

Despite relatively high rates of output growth in 1997, there was little improvement in the labour markets of most transition countries. Employment growth in *eastern Europe* was still sluggish in 1997, with a significant increase (some 1.5 per cent) only in Poland, where strong output growth continued for a fourth consecutive year (table 1.2.6). Among the *Baltic states*, employment increased relatively strongly in Latvia in 1997 (by almost 2 per cent), and there was some improvement in Lithuania as well. In the *CIS countries* employment continued to fall in 1997 despite the improvement in the level of economic activity. Employment increased only in Kyrgyzstan, Tajikistan, Turkmenistan[17] and Uzbekistan; elsewhere it was either stagnant or continued to fall at much the same rates as in 1996. At the time of writing this *Survey* there are still no employment data for the first quarter of 1998 for the large majority of the countries, although total employment seems to have started to grow in Hungary.[18]

TABLE 1.2.6

Total and industrial employment in the transition economies, 1995-1997

(Percentage change over preceding year)

	Total employment			*Employment in industry*		
	1995	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	-0.5	0.5	..	-1.8	-0.6	..
Albania	-2.0	-1.9	-0.7	..	..	..
Bosnia and Herzegovina	67.8	69.4	0.1	105.1	..	..
Bulgaria	1.3	0.1	..	-2.2	-1.2	..
Croatia	-1.3	0.9	-3.6	-11.6	-0.9	-5.6
Czech Republic	2.6	0.7	-1.1	0.5	-0.8	-1.7
Hungary	-1.9	-0.5	0.2	-5.4	-0.9	1.7
Poland	1.8	1.9	1.6*	3.2	-0.7	0.4*
Romania[a]	-5.2	-1.2	..	-5.8	1.0	..
Slovakia	2.2	0.8	-0.5	-0.1	–	-2.0
Slovenia	-0.2	-0.5	-0.2	-3.8	-1.0	-4.2
The former Yugoslav Republic of Macedonia	-9.5	-4.4	-5.4	-13.2	-6.5	-7.6
Yugoslavia	-1.4	-0.5	-1.6	-2.5	-2.3	-3.1
Baltic states	-3.0	-0.7	..	-3.6	-4.1	..
Estonia	-5.3	-1.6	-0.5*	8.1	-4.4	..
Latvia	-3.4	-2.7	1.9	-5.7	-5.6	1.5
Lithuania	-1.9	0.9	0.6	-7.7	-3.1	-1.1
CIS	-1.0	-0.9	-1.0	-7.7	-5.1	-4.1
Armenia	-0.8	-2.8	-1.8	-14.7	-15.8	-3.9
Azerbaijan	-0.5	2.0	0.2	-14.6	-12.0	0.1
Belarus	-6.2	-1.0	0.1	-10.9	-1.2	-0.6
Georgia[b]	21.8	0.2	-1.7	-9.4	-28.1	0.8
Kazakhstan	-0.5	-0.5	-1.8	-9.4	-2.5	-3.8
Kyrgyzstan	-0.2	0.6	1.7	-15.0	-10.8	1.2
Republic of Moldova	-0.5	-0.8	-0.9	-14.2	-1.7	-1.3
Russian Federation	-3.0	-0.7	-0.8	-7.5	-4.7	-5.3
Tajikistan	-0.1	-6.6	2.8	-12.1	-1.1	1.1
Turkmenistan	0.5	-0.3	2.0	-0.1	3.7	2.9
Ukraine[b]	3.0	-2.1	-3.1	-7.7	-7.3	-3.1
Uzbekistan	0.9	1.3	1.4	2.4	1.3	0.2
Total above	-0.9	-0.5	..	-5.9	-3.9	..
Memorandum items:						
CETE-5	1.4	1.4	1.1	0.8	-0.7	..
SETE-7	-3.1	-0.9	..	-3.4	-0.5	..

Source: UN/ECE secretariat estimates, based on national statistics.

[a] End of year.

[b] The increase in total employment in 1995 was probably a result of the fuller coverage of individual farmers first done on the basis of the labour force survey.

Unemployment figures for the first few months of 1998 (table 1.2.7) suggest a continuation of the main tendencies seen in 1997. In *eastern Europe,* the average *rate of unemployment* in April 1998 was 11.7 per cent (0.4 percentage points less than a year earlier). In the 12 months to April 1998 it had fallen significantly only in Bulgaria, Hungary and, especially, Poland. The decline in Bulgaria actually occurred in March but it remains to be seen whether this can be maintained given the weak prospects for output growth. Although the unemployment rate in the Czech Republic remains well below the east European average, it has been growing as a result of austerity and restructuring measures. Government officials expect it to increase to some 5.5 to 6 per cent by the end of 1998, but some independent forecasters think it could reach 6.5-7 per cent.

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[16] Excluding changes in regulated prices.

[17] From 1996 onwards there have been no official data on Turkmenistan's output performance. Unofficial estimates suggest a substantial drop in GDP and industrial output in 1997 (table 1.2.1) due to disruptions in gas exports. However, this does not appear to have had a negative impact on employment for the time being.

[18] The Hungarian authorities expect a 2 per cent rise in employment in 1998. Reuters News Service, 7 January 1998.

TABLE 1.2.7

Registered unemployment in the transition economies, 1997-1998

(Per cent of labour force)

	1997		*1998*
	April	*December*	*April*
Eastern Europe	12.1	11.7	11.7
Albania [a]	12.6	14.9	16*
Bosnia and Herzegovina	..	..	..
Bulgaria	15.3	13.7	13.0
Croatia	16.6	17.6	17.6
Czech Republic	3.8	5.2	5.4
Hungary	10.8	10.4	9.8
Poland	12.1	10.5	10.2
Romania	7.0	8.8	9.3
Slovakia	13.0	12.5	13.2
Slovenia [a]	14.4	14.8	14.7
The former Yugoslav Republic of Macedonia [a b]	40.5	42.5	43*
Yugoslavia [a b]	26.7	25.6	26.5
Baltic states	6.4	6.3	6.7
Estonia [c]	5.7	4.6	5.1
Latvia	7.6	6.7	7.1
Lithuania	5.9	6.7	6.9
CIS	6.5	6.2	6.3
Armenia	10.0	11.0	8.8
Azerbaijan	1.2	1.3	1.4
Belarus	3.7	2.8	2.5
Georgia	2.6	2.6	2.0
Kazakhstan	4.3	3.9	4.1
Kyrgyzstan	3.9	3.1	3.7
Republic of Moldova	1.4	1.7	2.2
Russian Federation [d]	9.7	9.0	9.2
Tajikistan	2.4	2.8	2.9
Turkmenistan	..	..	..
Ukraine	2.0	2.8	3.3
Uzbekistan	0.4	0.3	0.4
Memorandum items:			
CETE-5	10.7	9.9	10.0
SETE-7	13.6	14.2	14.5
Russian Federation [e]	3.5	2.8	2.7

Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

[a] March.

[b] The data on employment cover only the social sector in agriculture, hence unemployment rates are biased upwards.

[c] Job seekers.

[d] Based on monthly Russian Federation Goskomstat estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking and available for work.

[e] Registered unemployment.

In the *Baltic states,* unemployment rates in the 12 months to April 1998 declined in Estonia and Latvia, but further increased in Lithuania and ranged between some 5 to 7 per cent.

In the *CIS countries,* in the first four months of 1998, unemployment was broadly unchanged compared with the same period of 1997 and the officially registered unemployment rates still remained very low.

(e) Trade and payments

Trade

According to preliminary data, *east European and Baltic exports* continued to expand rapidly in the first quarter of 1998, their total increasing by 12 per cent in dollar terms (year-on-year), thus continuing an acceleration which was already underway in the last months of 1997 (table 1.2.8). In the Czech Republic, Slovakia and Slovenia, export growth accelerated to two-digit rates in both dollar value and volume terms.[19] In Bulgaria and Croatia, however, exports fell by 9 per cent, while in Romania they stagnated in value. In Poland the situation is not very clear: according to preliminary customs data, Polish exports grew at slightly more than 1 per cent (year-on-year) in January-February whereas the balance of payments statistics indicate an increase of 14 per cent in the same period;[20] given the continuing strong growth of domestic demand and industrial output, however, the former figure seems improbable. Exports from the Baltic countries also grew rapidly, at an aggregate rate of nearly 18 per cent, but there was a slowdown in Estonian exports which had increased by a record 40 per cent in 1997.

In volume terms, the growth of exports from eastern Europe and the Baltic economies was probably close to 20 per cent in the first quarter, as export dollar prices fell by 5-8 per cent in the five countries which report these data (the Czech Republic, Estonia, Hungary, Latvia and Slovenia). The strong growth of industrial output in many of these countries in the first months of 1998, on the one hand, and the steady rise in western import demand since the second half of 1997, on the other, appear to be among the principal factors behind this expansion.

Although outpaced by exports, *east European imports* also grew quite strongly if compared with the same period of 1997. Increases were in the range of 12-20 per cent in Bulgaria, Hungary, Slovakia and Slovenia. However, imports into Croatia and Romania fell in value, while Czech import growth (1 per cent) was restrained by the policies introduced in mid-1997. The surprisingly strong growth of Bulgarian imports (15 per cent) in the first quarter of 1998 mainly reflects the record low import levels in January-March 1997 when the Bulgarian economy was in a deep crisis and the lev was depreciating rapidly.[21] (Slovenia's imports in this period were boosted by the purchase of two aeroplanes at the

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[19] In January-February 1998, export volume rose 26 per cent, year-on-year, in the Czech Republic and nearly 14 per cent in Slovenia.

[20] A similar discrepancy appears in the import statistics: while the customs statistics show an increase of 2.2 per cent year-on-year, the balance of payments statistics give 10 per cent. The only explanation offered by the official statisticians is the lag between customs declarations and payment procedures but this does not seem to be a sufficiently plausible reason for such large discrepancies.

[21] Bulgarian January-March imports were within the range of the levels recorded during the preceding three quarters ($1.1-$1.3 million).

TABLE 1.2.8

Trade performance and external balances of the ECE transition economies, 1997-1998

(Growth rates in per cent; values in billion dollars)

	Export growth		*Import growth*		*Trade balances*		
	1997	*1998 QI*	*1997*	*1998 QI*	*1997*	*1997 QI*	*1998 QI*
Eastern Europe	6.0	11.8	6.1	7.4	-38.0	-6.5	-5.9
Albania	-35.6	130.9	-32.1	52.7	-0.5	-0.1	-0.1
Bosnia and Herzegovina	87.4	..	29.2	..	-1.4	..	..
Bulgaria	0.5	-8.9	-3.7	15.8	–	0.2	0.2
Croatia	-7.6	-8.4	16.9	-5.4	-4.9	-0.9	-0.9
Czech Republic	2.8	18.1	-2.7	1.1	-4.4	-1.4	-0.5
Hungary	21.4	26.0	16.3	20.9	-2.0	-0.6	-0.6
Poland	5.4	1.5	13.9	2.2	-16.6	-2.4	-2.5
Romania	4.3	-0.2	-1.4	-10.5	-2.8	-0.2	-0.4
Slovakia	0.2	13.8	-8.0	12.2	-1.4	-0.5	-0.5
Slovenia	0.8	8.5	-0.7	9.0	-1.0	-0.3	-0.3
The former Yugoslav Republic of Macedonia	4.7	..	7.0	..	-0.5	..	..
Yugoslavia	28.7	9.8	16.7	7.5	-2.4	-0.4	-0.4
Baltic states	22.8	17.8	26.5	19.0	-4.3	-0.9	-1.1
Estonia	40.1	19.2	36.7	18.1	-1.5	-0.3	-0.4
Latvia	15.8	25.1	17.4	28.5	-1.1	-0.2	-0.3
Lithuania	15.1	13.7	23.8	15.5	-1.8	-0.4	-0.5
CIS [a]	-0.3	-10.7	9.0	14.0	28.3	8.6	2.7
Armenia	-19.7	54.1	4.3	4.1	-0.7	-0.2	-0.1
Azerbaijan	23.8	-33.5	-17.4	6.9	–	–	-0.1
Belarus	26.5	9.5	24.6	14.7	-1.5	-0.4	-0.6
Georgia	25.6	5.4	35.5	28.3	-0.7	-0.1	-0.2
Kazakhstan	7.7	-6.8	0.8	14.7	2.1	0.7	0.5
Kyrgyzstan	19.6	52.4	-15.4	17.0	-0.1	-0.1	-0.1
Republic of Moldova	9.7	-1.7	8.9	5.5	-0.3	-0.1	-0.1
Russian Federation	-1.8	-14.4	14.4	21.4	33.2	9.9	4.6
Tajikistan	-3.1	-12.7	12.3	10.3	–	–	-0.1
Turkmenistan	-55.6	-74.6	-6.5	-31.1	-0.5	0.1	-0.1
Ukraine	-0.7	9.7	-2.8	4.4	-2.9	-1.2	-1.1
Uzbekistan	-0.2	-18.4	-4.5	-16.3	-0.3	0.1	–
Total above	3.1	-0.2	8.1	10.6	-14.1	1.2	-4.3
Memorandum items:							
CETE-5	6.8	14.6	6.2	7.6	-25.4	-5.1	-4.3
SETE-7	2.8	1.5	5.7	6.3	-12.6	-1.3	-1.6

Source: National statistics.

Note: Data for January-February in cases of Poland and Yugoslavia. For Bulgaria and Romania growth rates and trade balances for the 1st quarter 1998 are derived from the balance of payments data. On regional aggregates, see note to table 1.2.1.

[a] Data refer to total trade (non-CIS plus intra-CIS).

beginning of the year.) In the Baltic countries, imports slightly outpaced exports; however in Estonia, the rate of import growth was just one half of the previous year's rate (same for exports).

In aggregate, *east European and Baltic imports* in the first quarter of 1997 were 8 per cent higher than a year earlier. In volume terms, the increase was still larger, since there were large falls in the unit dollar values of imports. Falling world commodity prices were the main factor behind this development.

In January-March 1998, the deterioration of trade balances, a major feature of 1997, slowed down or was even arrested in most of the east European countries (Poland being a notable exception) but not in the Baltic states. The aggregate trade deficit of eastern Europe and the Baltic states amounted to $7.0 billion (about $7.3 billion in January-March 1997). In absolute terms, the largest, and still increasing, deficit was in Poland ($2.5 billion in January-February). In contrast, there was a large reduction in the Czech trade deficit and also some improvement in Hungary. In both countries, the improvements were partly due to a fall in the value of imports from east European and CIS countries, mainly a reflection of lower prices for oil and gas. But the Czech trade deficit vis-à-vis the developed market economies was also halved, a result of relatively strong export growth.

In the first quarter of 1998, relative to the corresponding period in 1997, the total dollar value of *CIS* exports fell by 11 per cent, heavily influenced by a

TABLE 1.2.9

CIS countries' trade with CIS and non-CIS, 1997-1998

(Value in million dollars, growth rates in per cent)

	Export growth		*Import growth*		*Trade balances*		
	1997	*1998QI*	*1997*	*1998QI*	*1997*	*1997QI*	*1998QI*
Armenia							
Non-CIS	-15.0	23.2	2.6	11.5	-456	-104	-114
CIS	-26.0	110.5	8.0	-6.7	-205	-50	-31
Azerbaijan							
Non-CIS	18.1	-55.1	-28.6	7.2	-40	8	-59
CIS	30.4	1.8	3.3	6.4	27	-7	-10
Belarus							
Non-CIS	1.8	-16.7	21.1	32.0	-947	-96	-357
CIS	38.8	21.1	26.4	7.4	-550	-333	-215
Georgia							
Non-CIS	60.7	-18.5	42.2	44.2	-479	-92	-145
CIS	6.6	33.5	25.4	2.5	-202	-52	-48
Kazakhstan							
Non-CIS	28.7	-6.4	51.9	38.9	1 547	502	319
CIS	-10.3	-7.2	-21.7	-2.1	545	200	161
Kyrgyzstan							
Non-CIS	154.0	188.3	-22.0	36.5	11	-22	10
CIS	-18.8	-11.0	-10.5	8.1	-117	-46	-61
Republic of Moldova							
Non-CIS	5.7	-10.7	37.3	51.2	-300	-54	-113
CIS	11.7	2.0	-8.9	-22.7	5	-45	-4
Tajikistan							
Non-CIS	7.7	-12.1	-6.1	-20.3	205	37	38
CIS	-17.5	-14.6	26.1	28.0	-209	-56	-97
Ukraine							
Non-CIS	24.0	11.8	11.2	9.4	1 398	343	415
CIS	-24.1	6.9	-11.0	2.0	-4 294	-1 578	-1 549
Total above							
Non-CIS	21.5	1.2	15.4	20.2	938	521	-5
CIS	-4.0	8.0	-2.7	2.9	-5 000	-1 966	-1 854
Russian Federation							
Non-CIS	-3.3	-18.5	22.4	26.1	30 565	8 742	3 681
CIS	5.4	3.3	-3.0	9.1	2 594	1 140	1 004
CIS total							
Non-CIS	0.5	-15.2	20.4	24.5	31 503	9 263	3 676
CIS	0.6	5.4	-2.8	5.1	-2 406	-826	-849

Source: CIS Statistical Committee, direct communication to the ECE secretariat. Data for Turkmenistan and Uzbekistan are not available.

14 per cent fall in Russian exports (table 1.2.8). CIS imports continued to grow, especially in Russia, and the aggregate trade surplus declined by almost $6 billion. [22]

Falling commodity prices have clearly had a negative impact on the export earnings of Russia and other CIS primary commodity producers. Despite a 9 per cent increase in their volume, the dollar value of Russian crude oil exports declined by over 20 per cent in the first two months of 1998. Revenue from exports of petroleum products was almost 50 per cent lower than in the first two months of 1997. [23] Moreover, the average contract price for Russian gas exports in the first quarter of 1998 was 15.5 per cent lower than in the same period of 1997: export volume rose slightly but revenue declined by nearly 15 per cent. [24] Similarly, export declines in Azerbaijan and Kazakhstan largely reflect lower oil prices. Individually, only Armenia, Belarus, Georgia and Ukraine increased their total exports in the first quarter. On the import side, there were increases in all countries, except Turkmenistan and Uzbekistan, where there were large falls in both exports and imports.

The value of *Russia's non-CIS exports,* which represent about 80 per cent of its total exports, was $13.4 billion in the first quarter of 1998, 19 per cent lower than in the corresponding period of 1997 (table 1.2.9). As noted above, the principal reason for this decline was the fall in world commodity prices for Russia's main exportables, particularly crude oil and petroleum products, but also for natural gas, coal, ferroalloys, copper and nickel. As these products account for about two thirds of Russia's exports, lower commodity prices have had a significant negative impact on earnings. [25]

The value of Russian imports, however, has continued to increase strongly, maintaining the upsurge that had begun in the second half of 1997, and the merchandise trade surplus with non-CIS countries in the first quarter of 1998 was almost 60 per cent lower than a year earlier. In real terms, the rouble has continued to remain relatively stable against the dollar but has appreciated against the European currencies due to their depreciation vis-à-vis the dollar. This in turn may have encouraged increased purchases of imported goods.

The dollar exports of *other CIS countries* to non-CIS countries in the first quarter were unchanged from a year earlier but their imports from them increased by 20 per cent. [26] For the group as a whole, trade was more or less balanced in the first three months of 1998, a slight deterioration relative to 1997 when there was a $0.5 billion surplus.

In dollar terms, *intra-CIS trade (exports and imports)* increased by 5 per cent in the first quarter. In the first two months of 1998, Russian oil supplies to the other CIS countries increased by 26 per cent (to 3 million tonnes). Oil prices for deliveries to CIS countries increased by about $5 per tonne to $104 per tonne, or $14 more than the price received in non-CIS markets. The value and volume of exports of a range of other products, such as pig-iron, ferroalloys, methanol and newsprint, also increased. The increases in Russia's shipments to the CIS, however, were not sufficient to prevent the overall decline in its export receipts.

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[22] All the figures reported here exclude "shuttle trade".

[23] ITAR-TASS News Agency, Moscow, 21 April 1998, as quoted in *BBC Summary of World Broadcasts*, 1 May 1998.

[24] *Russkyi Telegraf*, 22 May 1998.

[25] In response, the Russian government has cut the export transport tariff in half, from $3 to $1.5 a tonne, and postponed plans to impose an excise tax on pipeline use to ease the oil sector's financial burden.

[26] As there are no trade data by destination available for Turkmenistan and Uzbekistan, these countries are excluded from table 1.2.9.

The other CIS countries also increased their mutual trade. This was not a uniform development: in the large CIS economies, such as Ukraine and Belarus, exports and imports increased, but in Kazakhstan they declined. The effects of the Belarusian currency crisis, which culminated in March 1998, with the currency depreciating by about one half against the Russian rouble, are likely to be reflected in the second quarter trade statistics. The early 1998 intra-CIS trade balances were similar to those in early 1997 – Russia ran a $1 billion surplus while the other CIS countries recorded a $1.9 billion deficit. Only Kazakhstan had a positive balance of trade with the other CIS countries.

External financial developments

In 1997 the *aggregate current account deficit of eastern Europe* increased, to $14.6 billion (or an average 4.2 per cent of GDP – table 1.2.2), but this was considerably less than had been expected at the beginning of the year when external balances were deteriorating rapidly. Croatia, the Czech Republic, Poland and Slovakia were expected to show the largest increases in their deficits. Although the specific factors at work and the policy measures taken by their governments are different, the latter three countries as well as Hungary have reported some of the largest improvements relative to initial expectations. Croatia's deficit did increase sharply (to $2.4 billion or 11.7 per cent of GDP),[27] although this appears to have been due mainly to exceptional imports in the last quarter of the year, in anticipation of the introduction of value added tax. Romania's deficit ($2.5 billion) again substantially exceeded the initial target. The large current account deficits of the *Baltic states* continued to rise in 1997, and by more than expected. In general, these deficits were easily financed by foreign direct investment (FDI) and, to a lesser extent, by external borrowing, although over the last few years the latter has resulted in large increases in the external debt of several countries. However, foreign currency reserves rose as well.

In *Russia,* the current account surplus fell to around $3 billion in 1997. The decline, which was much greater than anticipated, was due to higher merchandise imports, rising interest payments abroad and lower export revenue resulting from falling commodity prices. The *other CIS countries* have been generally running current account deficits, which in most cases appear to have increased in 1997.

The picture for 1998 remains mixed. Incomplete returns for the first quarter of 1998 and various forecasts suggest that the current account deficits of most transition economies will remain relatively high, although several of them are expected to fall. While in general there appears to have been little difficulty in financing these deficits, they remain a worrisome feature of economic developments in the transition economies, particularly in the current turbulent state of the international economic environment.[28]

The increasing *access to the international financial markets* enjoyed by the transition economies was interrupted by the Asian crisis. At the end of October 1997, borrowing conditions for most emerging market economies deteriorated dramatically, causing widespread postponement of new loans, bonds and equity issues. As a result, the transition economies raised only about $1.5 billion in medium- and long-term funds in the first two months of 1998 compared with nearly $30 billion in the whole of 1997.[29] Subsequently, investor confidence recovered somewhat, margins on new debt declined (although, they still remain above their pre-October 1997 levels), and in April borrowing picked up, with entities representing ten transition economies raising at least $7 billion in January-May. Large intercountry differences in terms indicate that lenders are clearly differentiating between borrowers. A number of countries with the highest credit ratings in the region did not in fact need to borrow, their problem being rather to discourage inflows (attracted by high domestic interest rates) and to hold back the appreciation of their exchange rates. Large capital flows into Poland, which accelerated in the first quarter of 1998, continue to pose a challenge for economic policy.

At the end of May, events in Indonesia and the Republic of Korea again sapped investors' confidence in emerging markets: stock market prices generally declined, margins on internationally traded debt widened again, and borrowing plans, including those of some transition economies, were placed on hold. The Moldovan authorities actually cancelled the country's first Eurobond issue. Russian currency and equities markets were the hardest hit and there was increasing concern at the possible spillover to neighbouring countries, but so far the contagion appears to be limited. In this uncertain climate, Russia managed to raise a $1.25 billion bond, albeit at the cost of a large risk premium,[30] which helped to shore up its international reserves.

(ii) Financial distress in Russia

At the beginning of 1998 the outlook was relatively promising for the Russian economy. More than two years of steady disinflation and successful exchange rate management (providing a much needed predictability of the exchange rate) set the stage for a relatively stable macroeconomic environment. And, probably most important, after seven years of transitional depression, the economy appeared to be turning the corner: a small but still positive GDP growth was reported for 1997.[31] Russian financial markets were hit by fallout from the Asian crisis in November-December 1997, but at that time the negative impact turned out to be relatively limited. The optimistic view of the government at the start of 1998 was reflected in the growth targets for 1998 which were initially set in the range of 2-4 per cent.[32] In turn, between mid-February and mid-March, the Central Bank of the Russian Federation cut its refinancing rate in three steps from 42 per cent to 30 per cent.

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[27] This figure reflects Croatia's current account calculated on the basis of new statistical procedures. Under the previous methodology the deficit would have been even larger: thus, the revision lowers the deficit for 1996 from $1,455 million to $881 million. UN/ECE, *Economic Survey of Europe, 1998 No. 1*, p. 148.

[28] In Russia the current account may have moved into deficit in early 1998 due to the sharp deterioration of the merchandise trade surplus. The current account is likely to remain under pressure given the further fall in oil prices in mid-June and rising debt service obligations.

[29] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, table 3.6.22.

[30] The margin was 650 basis points, compared with 345 basis points on Russia's previous five-year dollar bond.

However, subsequent developments took a negative turn and bad economic news started to emerge and accumulate in the second quarter. The weak signs of recovery began to fade with the publication of zero growth figures for the first quarter (implying falling output in March). The April figures did not show any improvement and confirmed that GDP had remained flat in the first four months of the year. At the same time the situation with wage arrears – a recurrent problem for the Russian economy – started to worsen. In 1997, thanks to a concerted effort and partly using the proceeds from foreign borrowing, the Russian government managed to reduce the stock of outstanding wage arrears in the final months of the year. However, wage arrears began to increase rapidly again in January 1998 and by the end of March the combined stock of public and private sector arrears had reached a record level.[33] Discontent about unpaid wages was behind the wave of coalminers' strikes which escalated in May with the blockade of railroads throughout Russia, including the vital Trans-Siberian route.

The deterioration of the economic situation in 1998 is at least partly due to the sharp fall of commodity prices: as noted earlier, this has led to a substantial fall in export revenues. It is important to note that the negative impact of this fall is not confined to the corporate sector but also affects Russia's external balances[34] and the public finances.[35] The large negative effect of the fall in commodity prices highlights a major vulnerability of the Russian economy: due to its narrow specialization in exports of primary commodities and its high degree of dependence on this source of export revenue, Russia is especially prone to external shocks caused by cyclical fluctuations in world market prices and demand.[36]

As a result of this deterioration in external economic conditions but also because of chronic deficiencies in the fiscal system (see below), budget revenues in the first few months of 1998 were well below target, thus generating an excessive fiscal gap. The obvious lack of progress in coping with the budget deficit has led to mounting tension in relations with the IMF and the release of funds under the three-year Extended Fund Facility (EFF) was de facto suspended. The soaring fiscal deficit was partly covered by new foreign borrowing (DM 1.25 Eurobond issue in mid-March) and the Russian authorities have also announced plans to speed up some large privatization deals to attract foreign investors.

However, the accumulation of bad economic news increased the pressure on Russian financial markets where investors were already anxious in the aftermath of the Asian crisis. The totally unexpected change of government at the end of March added further uncertainty to an already deteriorating situation. The manner in which the change was made conveyed to the markets a perception of low predictability of the political process in Russia.

The increased borrowing requirements of the government started to raise the yield on short-term treasury bills (GKOs) and in mid-May the Central Bank of Russia also raised its Lombard rate from 30 to 50 per cent. Another setback was the failure of Tokobank, one of the largest Russian banks,[37] which was placed under conservatorship by Russia's central bank on 7 May after facing grave liquidity problems. Weary foreign investors then started to pull out of the GKO market and out of the rouble.[38] Probably the last straw was the failure of the auction of a 75 per cent stake in the oil giant Rosneft: by the deadline of 26 May, the auction had failed to attract a single bid at the initial offer price of $2.1 billion which, if successful, would have provided much needed funds for financing the budget deficit and replenishing the foreign reserves.

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[31] It should be noted that the accuracy of Russian statistical data has often been questioned by a number of experts both in and outside Russia. For example, in 1995, a comprehensive study under the leadership of the World Bank produced a major upward revision of previous estimates of the output decline in Russia during the first phase of the transition (World Bank-Goskomstat, *Russian Federation: Report on the National Accounts* (Washington, D.C.), October 1995). Subsequently, it has been argued by some observers that the frequent revisions of statistical data by the Russian State Statistics Committee (Goskomstat) are sometimes made in a rather arbitrary and ad hoc manner. The June 1998 corruption scandal at the Goskomstat involving a group of high-ranking statistical officers (who allegedly deliberately distorted statistical data) casts further doubts on the reliability of Russian statistics.

[32] "Dvenadtsat' del pravitel'stva Rossii na 1998 god v oblasti ekonomicheskoy i sotsial'noy politiki", *Rossiiskaya gazeta* (Moscow), 28 January 1998.

[33] Working Centre for Economic Reform/Russian European Centre for Economic Policy, *Russian Economic Trends*, Monthly Update (Moscow), 7 May 1998, p. 9.

[34] The current account (table 1.2.2) had already deteriorated more than expected in 1997 (it was in deficit in the third quarter of 1997). While the trade balance in the first quarter of 1998 remained positive, it was some $5.2 billion smaller than the surplus recorded in the first quarter of 1997 (table 1.2.9).

[35] According to Deputy Minister of Finance Aleksei Kurdin, oil-related budget revenues alone are likely to fall some $1.5-$2 billion below expectations in 1998. Natsional'naya Sluzhba Novostei, Biznes-novosti, 12 May 1998 (http://www.nns.ru/chronicle/business/).

[36] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, p. 10.

[37] Excessive borrowing in 1997 had increased considerably the exposure of Russian financial institutions to foreign credit, some of which was maturing in 1998, and demand for foreign exchange was rising on the Russian currency market. According to estimates of Capital Data Loanware, quoted by *Russia Today*, syndicated loans to Russian entities in 1997 amounted to over $7.5 billion with Russian banks receiving more than $2.3 billion. Over $565 million of syndicated loans to Russian banks are due to be repaid in July and August 1998. *Russia Today*, 21 May 1998 (http://www.russiatoday.com/).

Financial turmoil culminated in the last week of May. The continuing rise in the yield on GKOs[39] was followed by a large fall in stock market prices.[40] The rouble came under growing pressure and the monetary authorities intervened heavily on the foreign exchange market. On 27 May, the Central Bank of the Russian Federation raised its refinancing rate to the crisis level of 150 per cent as a last resort to defend the currency. This measure, together with a concerted public campaign by top-level Russian officials proclaiming their resolve to prevent a major crisis and avoid a devaluation of the national currency, managed to calm the financial turmoil. The IMF resumed funding under the EFF thereby signalling support for the main lines of the reform process in Russia,[41] a move aimed at restoring investors confidence.

Subsequently, interest rates began to fall and the pressure on the rouble weakened. On 3 June, Russia successfully placed a new issue of Eurobonds ($1.25 billion), although at a punitively high interest rate premium. On 4 June, Russia's central bank reduced its refinancing rate to 60 per cent. The Russian authorities announced a comprehensive anti-crisis programme focusing, on the one hand, on a drastic reduction and restructuring of public spending and, on the other, on boosting public revenue. The draft envisages, *inter alia*, cutting more than 200,000 government jobs, consolidating extrabudgetary funds, a further reduction of state orders and budget subsidies, and reform of the system of fiscal transfers from the federal budget to the regions. On the revenue side, despite lowering the revenue projections (to make them more realistic), the programme targets new sources of budget income through a more rapid collection of back taxes, raising the efficiency of the tax collection system, and amending a number of tax laws to allow a faster rate of tax collection. In addition, the programme envisages speeding-up the privatization process in order to raise additional revenue. Altogether this set of measures would amount to a cut in public spending equivalent to 1 per cent of GDP and extra revenue equivalent to 0.8 per cent of GDP.[42]

At the time of writing this *Survey*, the outlook is not at all clear. Russian financial markets continue to be characterized by a high degree of volatility, and considerable uncertainties about the future remain. Although this latest crisis was confined to the financial markets, it does reflect a number of persistent and fundamental problems in the Russian economy and these seem to have been the main cause of the turmoil despite an apparent contagion effect from the Asian crisis. At the core of these problems is Russia's chronic fiscal imbalance and the manner in which it is being financed.

Russia has been running large budget deficits for a number of years.[43] Consequently – and in addition to the fact that it inherited the bulk of the foreign debt of the Soviet Union – the Russian public debt has been growing rapidly. At present, Russia's total public debt (foreign plus domestic debt, excluding public sector wage arrears and overdue payables to government suppliers) is estimated at around 50-55 per cent of GDP.[44] Although by international standards this ratio of debt to GDP is not very high, its actual impact needs to be judged in relation to other macroeconomic variables.

For example, taking into account the fact that the total revenue of Russia's federal budget in 1996-1997 amounted to just 11-12 per cent of GDP,[45] Russia's public debt is already 4-5 times larger than the annual budget revenue, and domestic debt alone is some 2-2.5 times higher than the annual revenue of the federal budget. In turn, the level of Russia's gross foreign debt is some 1.5 times higher than the value of total annual export earnings. Obviously the strain on the federal budget stemming from the servicing of this level of public debt is already considerable: interest expenditure in the revised 1998 budget was estimated at 4.8 per cent of GDP[46] (however, this share is likely to become even higher if the pressure on the securities markets persists). The great danger is that if public debt continues to grow at its present rate, it may soon snowball out of government control despite the fact that its level may not be comparatively high at present.[47]

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[38] According to a statement by the First Deputy Chairman of the Central Bank of the Russian Federation, during the second half of May foreigners withdrew between $500 million and $700 million from the Russian government securities market. *Russia Today*, 29 May 1998 (http://www.russiatoday.com/).

[39] Between 25 and 27 May alone the yield spiralled from 50-53 per cent to 70-75 per cent. Credit Suisse/First Boston, *Emerging Markets: Weekly Update*, 27 May 1998.

[40] On 27 May the price of the most liquid shares on the Moscow stock exchange fell by some 12-15 per cent. Natsional'naya Sluzhba Novostei, Chronika poslednikh novostei, 27 May 1998 (http://www.nns.ru/chronicle/).

[41] At the same time, however, the IMF reiterated the need to deepen reforms in Russia. International Monetary Fund, "Russian Authorities and IMF Reach Understanding on 1998 Economic Policy Statement", *News Brief*, No. 98/20 (Washington, D.C.), 11 June 1998.

[42] Reuters News Service, 1 June 1998; *Financial Times*, 5 June 1998; Oxford Analytica, "Russia: fiscal federalism", *Oxford Analytica Brief*, 8 June 1998.

[43] There are different estimates of the Russian budget deficit due to the fact that Russia has only recently adopted international standards, namely, the IMF's Government Finance Statistics – GFS, in the compilation of its fiscal accounts. One major distortion before 1998 resulted from the treatment of interest paid on discounted treasury bills (GKOs): following the Russian methodology, the latter was treated as financing (and thus not reflected in the deficit) and not as interest expenditure. Thus, according to the Russian definition, the deficit in the consolidated federal budget in 1997 was 3.2 per cent of GDP whereas the IMF estimated it at 6.5 per cent of GDP. See Working Centre for Economic Reform/Russian European Centre for Economic Policy, *Russian Economic Trends*, No. 1 (Moscow), 1998, p. 78. As of 1 January 1998, the Russian Ministry of Finance has reportedly started to use the GFS methodology.

[44] See Bank of Finland Institute for Economies in Transition, *Russian Economy, The Month in Review*, No. 2 (Helsinki), 1998; Oxford Analytica, "Russia: devaluation threat", *Oxford Analytica Brief*, 11 June 1998. In addition, total wage arrears (including, however, public and private sectors) amounted to some 14 per cent of GDP in the first quarter of 1998. UN/ECE secretariat calculations on the basis of data from the joint database of the Working Centre for Economic Reform and the Russian European Centre for Economic Policy (http://cep.lse.ac.uk/datalib/ret/exceldb/).

[45] UN/ECE secretariat calculations based on data from Working Centre for Economic Reform and the Russian European Centre for Economic Policy, *Russian Economic Trends*, No. 1 (Moscow), 1998, pp. 76-78.

The second major structural weakness related to the fiscal imbalance arises from the financing of the budget deficit. Due to the very low level of monetization in Russia[48] and the persistent flight of capital abroad (resulting in a low level of savings deposited in the banking system),[49] the domestic funds available to finance the fiscal deficit are rather limited. Consequently, the Russian authorities have been forced to attract increasing amounts of foreign funds to finance the deficit: by selling treasury bills to foreigners and by borrowing directly from the international financial markets. This has resulted in an increase in the exposure of Russia to volatile short-term foreign capital: the size of these inflows has already reached alarming proportions in terms of their potential to disrupt the domestic financial markets.[50] The vulnerability of the Russian economy to an abrupt reversal in the capital flow is increased by the relatively low level of official reserves.[51] Consequently, a sudden capital outflow carries potential threats both to fiscal policy (by draining a major source of finance of the budget deficit) and to monetary stability (by triggering a speculative attack on the currency). These risks became tangible, albeit to a limited degree, during the financial turmoil in May.

The causes of the fiscal crisis in Russia are numerous, but a few of them can be mentioned here. The current tax code in Russia is notoriously complicated: tax-related issues are subject to tens of different pieces of legislation, often giving rise to confusing contradictions. Tax legislation allows for numerous exemptions which lead to abuse and evasion. In addition, tax collection procedures are inefficient and allow companies to defer tax payments on a large scale (the accumulation of huge tax arrears by a few large corporate entities has had an especially negative fiscal impact). According to anecdotal evidence, tax evasion in general (both by individuals and by companies) has been widespread since the start of economic transformation. Moreover, the Russian Duma has often voted legislative amendments implying increases in budgetary expenditure (especially as regards wages and pensions) which are not consistent with the budget that it had previously approved. The revenue projections incorporated in successive budgets have been persistently overoptimistic and actual revenue has been chronically below expectations. On some occasions the shortfall has forced the government to invoke the unpopular sequestration mechanism (applied in both 1997 and 1998).

All these factors have had a negative impact on tax revenues and have thus contributed to the emergence and persistence of the fiscal deficit in Russia and, as a consequence, to the escalation of the public debt. The Russian authorities now face the major challenge of designing and implementing a wide-ranging and comprehensive fiscal reform to restore order in the public finances and to prevent a further widening of the deficit. This seems to be the central requirement of the considerable policy effort which is needed in order to improve financial and macroeconomic stability in the country.

Closely related to this problem is the broader issue of institutional reforms, the implementation of which are fundamental for laying the foundations of a sustained economic recovery. Progress in building an appropriate institutional infrastructure for a market economy has been very slow and modest, especially in areas related to tax and corporate law as well as bankruptcy. The rule of law is still somewhat spasmodic and in some important areas of social life is being crowded out by rules and practices dictated by the interests of the newly born financial oligarchy, often in conjunction with organized crime and a bureaucracy which is often highly inefficient and lacking in transparency. These obvious institutional deficiencies underline the weakness of the state in its efforts to promote economic recovery. This crucial institutional hiatus cannot be closed by simply declaring policy goals or by the provision of emergency assistance; the creation of an effective institutional framework is a long-term process, which requires a long-term policy commitment by the domestic political class to a credible programme of reform.

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[46] *Financial Times*, 5 June 1998. As an illustration of the actual debt burden, this level of interest expenditure amounts to some 48 per cent of the total expected revenue of the federal budget and to 32 per cent of the total expenditure of the federal budget.

[47] See Bank of Finland Institute for Economies in Transition, *Russian Economy, The Month in Review*, No. 2 (Helsinki), 1998.

[48] In this regard, the Russian budget deficit is also very large in relation to money supply: for example the deficit of the federal budget in 1997 was equivalent to 41 per cent of the average level of broad money during the year and to 73 per cent of M1. UN/ECE secretariat computations based on IMF, *International Financial Statistics* (Washington, D.C.), June 1998.

[49] Working Centre for Economic Reform/Russian European Centre for Economic Policy, *Russian Economic Trends*, Monthly Update (Moscow), 7 May 1998, pp. 1-3.

[50] To measure the magnitude of the potential monetary impact of the capital inflows it is instructive to compare the latter with the size of Russia's monetary stocks. For example, the net inflow of portfolio investment to Russia (the bulk of which went to the government securities market) during the first three quarters of 1997 amounted to $17.1 billion, which was equivalent to 43 per cent of the average level of M1 in the period January-September and was 1.45 times larger than the absolute increase of the broad money stock during the same period. UN/ECE secretariat computations based on IMF, *International Financial Statistics* (Washington, D.C.), June 1998. In addition, as noted earlier, there was a substantial inflow of syndicated loans to Russia, some of which were also short term.

[51] Thus, in June 1997 reserves covered just 53 per cent of the short-term debt to foreign banks (which in itself is only a fraction of all short-term capital flows). See UN/ECE, *Economic Survey of Europe, 1998 No. 1*, p. 59. Viewed from a different perspective, the average level of official reserves during the first three quarters of 1997 amounted to just 92 per cent of the net inflow of portfolio capital in that period. UN/ECE secretariat computations based on IMF, *International Financial Statistics* (Washington, D.C.), June 1998.

Some concluding remarks

In view of the continuing financial instability, the short-term prospects for the Russian economy have deteriorated since the beginning of this year. In May, the Russian Ministry of Economics actually lowered its own forecast for GDP growth in 1998 to 0.5 per cent[52] while high-ranking officials have hinted that growth might in fact be zero.[53] However, the issue which has been worrying foreign portfolio investors most of all is the exchange rate of the Russian rouble. In January 1998, the Russian central bank switched to a zero nominal depreciation target, but widened the fluctuation corridor for the rouble to ± 15 per cent thus raising the exchange rate risk of investing in rouble denominated assets. The escalation of financial instability in May-June as well as the further widening and deepening of the financial and economic crisis in Asia, and the weakening of a number of Asian currencies, increased the concerns of foreign portfolio investors as to whether the Russian authorities would be able to maintain their exchange rate targets.

In the light of the increasing fiscal problems, a rouble devaluation (or allowing the nominal exchange rate of the rouble to depreciate by more than the pre-announced target) might indeed provide some temporary relief for the economy: it would boost the profit margins (and thus the taxable income) of commodity exporters and curb import growth; the real value of the outstanding domestic debt may be eroded by rising inflation, which would also provide the government with some additional revenue from the inflation tax. At the same time, a devaluation of the currency would represent a forced offset for the lack of progress in some important reforms and an implicit recognition of the policy failure to deal with some of the fundamental problems facing the economy.

As discussed above, the Russian authorities do not have sufficient resources to cope with a major run on the currency in the event of a loss of credibility by foreign portfolio investors. Technically this issue can be overcome if the international financial institutions and western governments are willing to provide Russia with sufficient resources to defend the currency. However, the implied moral hazard problem and the suggestion that such assistance might delay the implementation of much needed reforms has led many commentators to question the wisdom of such a move. However, the current situation in Russia presents a major policy dilemma both for the Russian government and not least for the international financial institutions and for western governments. Withholding international assistance might provide the incentive for a much stronger domestic commitment to the process of institutional and economic transformation; but, on the other hand, such a course might exacerbate the considerable economic and social problems in Russia with unpredictable consequences for the rest of Europe.

The only sustainable policy course towards financial – and thus macroeconomic and political – stabilization in Russia is to move ahead with a coherent and comprehensive programme of institutional reform in which the reorganization of the fiscal system should be the top priority. A firm and irrevocable commitment of the authorities to sound and predictable economic policies and the existence of credible and transparent institutions through which such policies can be implemented are basic requirements for economic stability and sustained growth. What is most needed to restore calm and stability to Russian financial markets is for such a programme to be seen to be put in place and for the authorities to be seen to be carrying it out.

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[52] Prime TASS, 18 May 1998.

[53] *Russia Today*, 21 May 1998 (http://www.russiatoday.com/).

PART TWO

ENTERPRISE AND BANK RESTRUCTURING IN THE TRANSITION ECONOMIES

PAPERS FROM THE ECE SPRING SEMINAR, APRIL 1998

INTRODUCTION

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This part of the current issue of the *Survey* contains a selection of papers prepared for the UN/ECE's Spring Seminar which this year was held in Geneva on 20 April 1998 and focused on the issues of enterprise and bank restructuring in the transition economies.[54] Unlike many similar meetings, ECE's Spring Seminar attempts to bring together not only academic researchers but also economists and policy makers working in government departments and central banks, as well as economists from other international organizations and from the private business sector. In choosing subjects for the Seminar the secretariat is naturally guided by the preoccupations of ECE member governments, but it also tries to avoid too narrow a concentration on technical matters at the expense of the broader range of interrelated issues that policy makers invariably have to handle simultaneously. Another characteristic of the Seminar is that although attended by officials from national administrations and central banks they speak as independent experts and not as national representatives. This feature, together with the decision not to attempt to draw up an agreed set of conclusions or policy recommendations, is intended to promote an open and frank exchange of views and experience from which national policy makers can draw their own conclusions. Finally, the seminar tries to follow a comparative approach to the analysis of economic issues in an attempt to draw some general lessons from the great variety of experience to be found in the 55 member countries of the ECE. This is a lot more difficult than it sounds and trying to test general hypotheses is particularly hazardous for the 27 transition economies of eastern Europe and the CIS, a group which is not only heterogeneous but for which the historical experience of transition is still relatively brief. In an attempt to reconcile these two perspectives the Seminar opened with two "general" papers which provide comparative overviews of developments and issues in the transition economies and these were followed by a set of case studies which seek to highlight not only the specific experience of individual countries but also some of the more puzzling intercountry differences in performance.

The issues of enterprise and bank restructuring have become particularly urgent in the last year or so and were heavily underlined by the Asian financial crisis in 1997 in which the fragility of domestic financial systems is judged to have played an important role.[55] Bank and enterprise restructuring has also become an urgent issue for the eastern candidates for membership of the European Union, since a condition of membership, laid down by the Copenhagen European Council, is that each candidate must have "a functioning market economy" and also be able "to cope with competitive pressure and market forces within the Union". The creation of a competitive, private enterprise economy, both via the creation of new firms and the restructuring of the old state owned enterprises, is in any case essential if the transition economies are to lay the basis for sustained growth and begin to catch up with the levels of development prevailing in western Europe. These subjects have not been ignored in academic and policy circles but they were kept somewhat in the background as priorities were focused initially more on macroeconomic stabilization, the liberalization of prices and international trade, and privatization. In particular, the task of restructuring the banks was relatively neglected in the early years of the transition process instead of proceeding hand-in-hand with the restructuring of the enterprise sector.[56] There are a number of reasons why reforming the banks is a key condition for restructuring the enterprise sector: it helps to enforce the hard budget constraint by breaking up the "cosy relationships" between banks and indebted enterprises whereby the latter are sustained by easy loans from the former; it should lead to a more efficient allocation of credit; and it should also help to strengthen the frameworks for corporate governance. At the same time, the creation of a viable and profitable corporate sector is itself one of the essential conditions for a stronger and more efficient banking system. The symbiosis between these two elements in the restructuring process was the reason for attempting to focus on both of them in a single seminar even though both of them already command a large literature in their own right.

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[54] Among the contributions which could not be included here because of a lack of space were case studies of restructuring in Kazakhstan and Uzbekistan by Dr. Yelena Kalyuzhnova, of the Centre for Euro-Asian Studies, University of Reading (United Kingdom), and a paper on "Monetary Arrangements and Exchange Rate Regime as a Macroeconomic Framework for Proper Enterprise and Bank Restructuring – The Case of Slovenia" by Prof. Dr. Ivan Ribnikar of the University of Ljubljana.

[55] See *Economic Survey of Europe, 1998 No. 1*, chap. 2.1.(ii) for an overview of the Asian crisis and chap. 3.2 for a discussion of its implications for the transition economies.

[56] This does not necessarily imply that the banks should have been *privatized* before or at the same time as the non-bank enterprise sector. Mochrie, Schaffer and Bevan argue, below, that there are several good reasons why privatization of the banks should follow that of the enterprise sector.

The opening paper by ***Mochrie, Schaffer*** and ***Bevan*** (MSB) provides an extensive review of the basic issues involved, the progress achieved and the problems encountered in creating a market-based enterprise sector and banking system. Their approach is to first identify a number of key pillars of the market economy which, in particular, support the creation of joint stock companies. These pillars include: the private ownership of property; clearly defined property rights that are tradeable and able to be used as collateral; effectual bankruptcy laws to underpin the enforcement of contracts; commercial laws that require full and transparent financial reporting; and, in the special case of the financial sector, an effective system of supervision and regulation. The transition process in general, and the restructuring of the enterprise sector in particular, is thus effectively the process by which these pillars are constructed and thereby provide the framework in which the relationships between individuals and enterprises engaging in voluntary exchange in a market economy can develop. At the same time these pillars constitute an institutional structure through which owners and creditors are able to exercise corporate governance which, in turn, drives the restructuring process. MSB do not advocate a significant role for government in this process nor do they consider that the institutional framework needs to be put in place before restructuring can get under way. Instead, they see privatization per se as creating a private sector constituency for reform of the legal system, the enforcement of property rights and so on. The role of government is to set the rules rather than be an active instigator of change. In assessing the progress of restructuring in the transition economies MSB draw on the extensive empirical analysis already made on the subject and usefully provide a number of short reviews of the literature concerning the construction of the "pillars" of the market economy.

Discussing MSB, ***Marek Belka***, not only an economist but also a former Deputy Prime Minister and Minister of Finance of Poland and thus someone with firsthand experience of grappling with these problems, agreed with the basic arguments of MSB but thought that as long as there were firm expectations of privatization the management of state owned enterprises would be motivated to start the painful process of restructuring before actual privatization. Belka also thought that closer investigation is required of the ways in which corporate governance structures are affected by differences in the ways in which privatization was conducted. ***Eugen Jurzyca*** also supported most of their arguments put forward by MSB and thought the description of the actual process of restructuring in the transition economies was an accurate one. He was not so sure, however, that the role of government should be downplayed as much as suggested by MSB: he saw the matter in more evolutionary terms with the government playing a larger role at the start of the transition process when, he emphasized, information about the future prospects of enterprises was limited or non-existent, but with market forces gradually playing an ever larger role in solving restructuring problems. Jurzyca also thought that a number of other preconditions should be added to MSB's pillars for an effective market economy, namely, that the political battles over ownership relations must first be settled and that experience, or learning-by-doing, had to be acquired before new institutions could be effective.

In the second paper, on reform of the banking sector, ***Elmar Koch*** looks at the issue from a central banking perspective. Although coming from the Bank of International Settlements, which is concerned to promote financial stability, particularly through the strengthening of supervisory and settlements systems, he stresses that the creation and maintenance of domestic financial stability is essentially the responsibility of national governments and their monetary authorities. Koch stresses the complexity of the task of restructuring the banking sector and of creating a system which is capable of *maintaining* stability in the face of an ever-changing economic and financial environment. But there is no simple formula for success and although "big bang" reforms have worked in some countries, he inclines towards a more cautious approach in the transition economies, not least because of the basic need to develop sound institutions and to grapple with the complexities of interdependencies and sequencing. In this context he shares the view that liberalizing financial markets, and especially the capital account in the balance of payments, is not sensible if the supervisory and regulatory framework is not in place or is still inadequate. Koch also places the task of creating a sound banking system within the broader framework of building the institutional structure for a market economy, and his paper discusses some of the key elements which are important for restructuring the banking sector, namely: the excessive direct involvement of governments in the financial sector in many transition economies; low degrees of monetization, which hold back the development of intermediation by the banks; and the need to strengthen the capital base of the banks. Matters for urgent and determined action include a solution of the bad loans problem in many countries; setting up and implementing effective systems for bank supervision; dealing with the existing failures in financial reporting; and, in some countries, allowing a more active participation of foreign banks. While much of his paper is concerned with the elements required to sustain a stable financial system, Koch's underlying theme is that fragility in the banks and other financial institutions undermines the prospects for real economic growth.

Discussing Koch's paper, ***David Kemme***, who agreed with most of its conclusions, stressed the increased vulnerability of countries with weak banking systems to external shocks of the sort experienced in South-East Asia in 1997. While noting that banking reform had made considerable progress in Poland, Hungary and the Czech Republic, for example, he argued that financial crises are now more likely to arise from the interaction between non-bank financial institutions and foreign capital flows rather than an "old-fashioned" bank collapse. This in turn requires an effective monitoring system of the foreign currency assets and liabilities held by the government and institutions in the financial sector, and a transparent and flexible exchange rate system that effectively puts a price on, rather than eliminates, exchange rate risk.

In his comments, ***István Székely***, sees the development of the financial systems in the transition economies as being driven by a number of key factors: namely, economic transformation itself, which alters relative prices and the net present value of existing loans; financial liberalization which permits and requires the financial institutions to respond to the relative price changes; the demands of "catching up" with western levels of economic development in a highly liberalized environment; and the requirements of future EU membership for institutional and legal reforms. Székely also stresses the importance of foreign participation in the domestic financial system, not as a source of quick or easy solutions, but of expertise and capital. But he stresses that foreign banks with reputational capital at stake are unlikely to take over a bank before its existing loan portfolio has first been restructured.

Discussion in the transition literature on enterprise and bank restructuring often focuses on the relation between microeconomic reforms and macroeconomic stability and on which direction causation is likely to run. However, in a paper which attracted a lot of discussion at the Seminar, ***Evgeny Gavrilenkov*** looks at a number of inconsistencies in the macroeconomic statistics for Russia and suggests that they may be quite misleading as a guide to the real performance of Russian enterprises, which he thinks may be more flexible and more capable of adjusting to changing economic conditions than is often thought. In particular he is puzzled by the existence of tens of thousands of large enterprises which continue to operate despite running apparently large losses and with government subsidies being cut. At the same time, real wages have risen and the consumption of goods and services has increased. What sort of an economy is this, he asks? The hypothesis put forward by Gavrilenkov is that Russia has reverted to a sort of dual monetary system where the "legal" rouble transactions between enterprises have largely been replaced by barter, the accumulation of a variety of payments arrears, and, in order to avoid paying taxes and penalties, by the settlement of accounts with each other in offshore banking centres (the latter mostly by large exporting firms). Arguing that the Russian authorities see the enterprise sector mainly as a source of tax revenue rather than as a producer of goods and services, he concludes that firms attempt to escape from the "grasping hand" of the government by developing an environment hidden from the official tax authorities and the statistical services. All these activities are facilitated by the dollarization of the economy and, while in the short run this helps to keep the enterprise sector working, in the longer run Gavrilenkov sees this as a serious impediment to sustainable growth. He points to a number of other obstacles at the micro-level to enterprise development – weak managerial and marketing skills, the existing accounting system which is a major obstacle to attracting foreign investors, and relationships between creditors and debtors which are conducted informally rather than through a stable and transparent institutional framework – but he also stresses the fact that, due to the fact that they could earn easier and larger profits from financial speculation and lending to the government, the banks had little incentive to lend funds to enterprises in the real economy and as a result have not developed the appropriate skills for evaluating projects and risk.

In commenting on Gavrilenkov's paper, ***Silvana Malle*** thought that his insights were very interesting but needed to be supported by harder evidence: this was especially the case for his conclusions that reported profits are low because they are being sent abroad and that Russian enterprises were settling transactions offshore to avoid taxation. There was certainly some evidence in support of these propositions, but there were other factors at work as well: capital flight was also a function of political and economic instability and of a number of more fundamental factors, including the lack of an appropriate institutional framework discussed in the previous papers, that were holding back investment and growth in the Russian economy.

It has sometimes been argued, particularly in the immediate aftermath of the revolutions of 1989, that the particular route to privatization was not very important: the crucial issue was simply to privatize and to do so as quickly as possible. The contributors to this Seminar did not share this view and, in particular, ***Pavel Mertlík***, in his paper, argues forcefully that the rapid privatization of the Czech economy through the voucher scheme was not very successful in creating an incentive structure and system of corporate governance that would encourage greater efficiency throughout the economy. One of the reasons for this was the unstable ownership structure that emerged via the Czech version of the voucher scheme: the investment funds (IFs), which became the leading actors in the newly privatized economy, found themselves with conflicting roles, as enterprise owners, on the one hand, and portfolio investment managers, on the other. This conflict was only resolved by subsequent changes in the regulations governing IFs which enabled a clearer institutional division of labour to emerge between these two functions. Mertlík also argues that the Czech voucher scheme imposed unnecessary costs on the economy: the process first led to a rapid deconcentration of the enterprise sector which was then put together again as the new IFs sought to consolidate and strengthen their ownership rights. The rebuilt structure closely resembled the pre-privatized one which existed under state ownership. Mertlík presents this not as an argument against privatization but as a critique of the particular method employed to achieve it which, he argues, was very costly and failed to establish effective corporate governance. He also argues that the extensive involvement of the banks as owners of Czech enterprises, rather than being a source of inefficiency, as is often claimed, seems to have been positive in establishing effective corporate governance and financial discipline. ***Marie Lavigne*** raised a number of important queries that were shared by many participants at the Seminar about the validity of his arguments about the costs and benefits of voucher privatization and the positive role of the banks as owners of enterprises, but doubts about the impact of the voucher scheme on corporate governance were earlier raised by Belka who was curious to see how the Czech authorities would resolve the governance problems created by this method of privatization.

The last paper presented here examines the problems of restructuring in the eastern *Länder* of Germany. East Germany is of course a "special case" in many respects, but it is still an economy in transition and rather than ignore it, as is frequently done in comparative studies of the transition process, it may well be instructive to look at the experience of enterprise restructuring in an economy that was released from many of the constraints facing the other transition economies by the availability of massive resource flows – financial and technical – from the west German economy. ***Alexander Eickelpasch*** notes that the introduction of the deutsche mark in eastern Germany was tantamount to a considerable exogenous shock, which rendered the bulk of the productive capital stock in the eastern Länder de facto obsolete. Strong upward pressures on wages, which drove unit labour costs above the west German levels, aggravated this real exchange rate shock. As a result, companies were unable to withstand the sudden exposure to fierce competition from firms in the western part of the country and the international economy at large and there was a collapse of industrial output and employment. Against this background, the federal government's strategy for the reconstruction of the east German economy was mainly based on the rapid privatization of state enterprises and a multitude of subsidies and other financial incentives designed to stimulate business fixed investment. Eickelpasch argues that six years after unification the results are mixed. Privatization was concluded in 1994. Fixed capital formation was robust and led to a substantial renewal of the manufacturing capital stock. On the other hand, there has been a considerable erosion of the industrial base. High unit labour costs continue to affect competitiveness and a considerable proportion of firms are still making losses. A persistent feature has been the weakness of the export performance of manufactures; sectors producing tradeables have experienced below average growth. In his paper, Eickelpasch presents interesting panel data concerning the economic performance of firms and the constraints which they have been facing. These data were compiled with the help of a questionnaire sent out to a large sample of east German industrial companies during 1991-1996. Not surprisingly, many of the privatized or newly created east German firms are facing the same start-up problems as new firms in the western market economies. Among these is the difficulty of developing competitive products and gaining market shares, a weak equity base, and the difficulty of obtaining finance from the banks. The data allow a comparison between the performance of firms which are subsidiaries of west German or foreign companies and those that are "independent". The general pattern is that the latter are more likely to face problems in particular areas (such as a too weak equity base and investment financing) than the former, but the overall differences appear to be rather small.

Michael Kaser, the discussant of Eickelpasch's paper, argues that Germany is facing a Mezzogiorno problem, the challenge being to integrate a backward economic region into one of the most advanced economies in the world. Estimates of the time required to catch up with west Germany range from 20 to 40 years. He points out that the overall performance of the east German economy appears in a better light if the comparison is made with the neighbouring transition economies of central and eastern Europe. Kaser wondered about the particular motives of western investors in east German industry and was concerned about the possibility that a large number of western subsidiaries in the new *Länder* would only be used as "long workbenches". If that is in fact the case, this would have implications for the longer-term development of the east German economy.

CHAPTER 2

ENTERPRISE AND BANK RESTRUCTURING IN THE TRANSITION ECONOMIES[57]

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This paper examines the processes by which firms and banks in the formerly centrally planned economies adapt to the conditions prevalent in existing market economies. Particularly at the enterprise level, some parts of transition occur quite naturally and certainly in the leading transition economies, these aspects were completed some time ago. Others, particularly those that rely upon the development of new institutions, including legal codes and changes in custom and practice, are difficult both to describe and to implement, and in this paper we attempt only to outline the forms that such changes might take. This approach contrasts with much of the earlier economic literature on transition, which tended to discuss transactions in more detail than relationships. Given the difficulties of being prescriptive when analysing non-market, relational problems among agents and the complexity of the changes necessary even yet to complete the transition, the paper concludes more by identifying possible future policy problems than by offering a range of solutions. Whereas at the start of the process, many observers favoured large-scale schemes in which government had the principal role, this paper argues generally for the greatest possible decentralization of problem solving, so that solutions emerge from the interaction of market participants rather than from plans developed by civil servants or international institutions. The role of government then becomes much more that of a setter of rules than a planner of actions.

2.1 The nature of market orientation

In a market economy, if an enterprise makes an invention and develops it successfully, it reaps an ample reward. If its competitors fail to match its performance, then they will suffer losses. The profits of the successful innovator lead to growth, but the losses of the tardy competitor lead ultimately to liquidation in which the enterprise is dissolved. Under central planning, this element of competition is absent. Since its capital was socialized and its managers did not stand to benefit from making unexpected surpluses, the highest aspiration of a manager was to fulfil the plan.

Relations between individuals in a market economy rely upon the principle of voluntary exchange. Both participants in a transaction must prefer participation to abstention. The rights of contracting parties are then determined explicitly by the terms of the contract into which they enter and implicitly by an extensive body of commercial law, the latter being particularly important where circumstances arise that were not foreseen when the contract was being prepared. It is particularly important that individuals can join together to subscribe to a joint stock incorporation or company. Each subscriber is a part owner of the company, usually with their liability for losses made by the company limited to the paid-up value of the equity or share capital of the company. The owners of the shares in a company have the right to dispose of them to third parties, usually without obtaining the approval of the other joint owners or the company itself, and for a consideration agreed between the buyer and the seller. The shareholders will normally appoint individuals, who need not be shareholders, to direct the affairs of the undertaking. These directors are accountable to the shareholders and must regularly report to them in respect of the financial standing of the company. As agents of the owners, the directors are empowered to bind the company and to enter into all types of transaction that the company can legally undertake. In particular they can enter into obligations, raising funds by borrowing, and can offer company property in security of such obligations.

(i) Enterprise structure

Companies exist in order to make profits and these profits belong to the owners, who may choose either to distribute them amongst themselves in the form of dividends, or else to reinvest them in the business of the company to generate further profits. In what follows, we focus almost entirely on joint stock companies, ignoring issues that might arise in respect of alternative forms of commercial organization, such as partnerships, public chartered companies and sole traders. Many unresolved issues in transition concern methods of supporting the development of joint stock companies, which have already emerged in central and eastern Europe (CEE) and the former Soviet Union as the predominant form of business entity. Support is necessary because the absence of private property precluded the formation of joint stock corporations under central planning and so the institutional framework that fosters their development in market economies was either never established or else permitted to atrophy.

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[57] We are grateful to our discussants, Marek Belka and Eugen Jurzyca, and to the participants at the seminar, for helpful comments and discussions. The paper draws on research based in the Centre for Economic Reform and Transformation, Heriot-Watt University, directed by Mochrie and Schaffer and funded by the European Union's Phare-ACE projects P96-6081-R and P95-2052-R, respectively. The views expressed in the paper are solely those of the authors.

We can identify three pillars in market economies that support the formation of joint stock corporations. The first is the private ownership of property, which as just discussed is the basis for the establishment of most private incorporations and institutions in these economies. Second, ownership presumes clearly defined property rights which are tradable and which may also be pledged to secure obligations. Third, such rights are likely to be valuable only if contract and bankruptcy laws permit the (rapid) enforcement of agreements and if commercial law requires enterprises to report fully and accurately their financial state, so that the financial standing of a company may easily be determined, reducing the uncertainty of trading considerably.

These pillars facilitate the accumulation of capital together with market-based trading relationships. The position of the directors of companies can quickly become anomalous, for if ownership of an enterprise is widely dispersed, as is likely if the undertaking is very large relative to individual incomes and wealth, then it will not be easy for owners to join together to discipline managers. This problem of the separation of ownership and control was first identified by Berle and Means (1932) and an extensive literature has developed in this area, particularly since the application of principal-agent analysis to it by Jensen and Meckling (1976). Surveying this work, Schleifer and Vishny (1997) argue for the establishment of block share holdings, so that control of a company rests in the hands of a small number of large shareholders. It is claimed that these large shareholders will then seek to exercise effective governance, scrutinizing the actions of management effectively, so that the company is run for the benefit of shareholders and generates high profits. Yet for large companies, such blockholders will normally be financial institutions, which are themselves companies, raising questions about the capacity of blockholders to provide effective scrutiny of managers. As will be shown below, the role of financial institutions in corporate governance is most important, whether they hold equity in companies or whether they are creditors, as is usually the case with banks.

(ii) Bank structure

It is possible to analyse the transition within the enterprise sector as if that sector, involving industries as different as agriculture, mining, tourism and pharmaceutical manufacture, were a single entity. However, there are good reasons for analysing developments within the financial sector separately. Enterprises within the financial sector, in particular banks, provide other enterprises with liquidity services (although the ability of enterprises to extend trade credit suggests that other enterprises also provide one another with certain liquidity services) together with the external funding for enterprises' capital investment. In addition, in mature economies, banks scrutinize borrowers' behaviour, ensuring that funds are used efficiently. Every bank therefore provides essential services to a large number of other enterprises. This means that the failure of even a single institution might have important effects within the enterprise sector.

In market economies, there is frequently a distinction drawn between Anglo-American and Continental banking systems. While not wishing to disregard the differences among systems, for our purposes these differences are of second order importance. In all market economies, the activities that banks undertake, and the roles that they enter into, are so similar that the differences between them need only be mentioned briefly. It is generally considered that the spectrum of possible banking systems stretches between the American and the Japanese ones. In the American system, there is separation of commercial banks, whose principal business is lending to corporations, and investment banks, who invest in corporations by holding equity or subordinated debt. Senior debt and equity then tend to be held by different institutions. In addition, relations between market participants are generally transaction based, with lenders agreeing to advance funds subject to the borrower meeting clearly defined performance conditions and offering adequate collateral to secure repayment of funds should the project fail. Banks have the right to initiate bankruptcy and other proceedings to recover whatever fraction of the outstanding liabilities may still be obtained when borrowers do not meet loan repayments. This is a very severe constraint upon the behaviour of the managers of a corporation, for such procedures usually lead to the dissolution of the company.

In such a system, owners tend not to seek to influence firm behaviour through direct control of the board of directors, preferring instead to threaten exit, which is usually possible because securities markets are very liquid. In contrast, the German system of universal banking permits institutions to take on roles that are separate in the American system, so that banks hold both debt and equity. Relationships are generally portrayed as being much more consensual in this system, with banks ordinarily appointing a number of members of the (supervisory) board of a company. It is often claimed that the development of close relationships between debtors and creditors fostered within such systems enable creditors to monitor and influence company policy directly without such heavy reliance upon the judicial and market-based disciplines used by American institutions. We consider that the type of financial system that emerges in any country depends upon the structure both of the economy and of existing legal and commercial institutions. Irrespective of details of their form, existing structures across market economies undertake very similar functions more or less equally successfully and so there does not appear to be any immediately obvious reason to prefer one over the others.

Banks, being a particular category of enterprise, are generally incorporated bodies in mature economies. They are therefore subject to the scrutiny of outsiders, being required to account for their behaviour to the holders of equity and debt in much the same way as other corporations. However, the role of banks as the providers of liquidity and the means of transmission of payments leads to governments regulating banks more vigorously than other firms, reinforcing the legal pillar. We note in particular that banking is unusual in that money is received by the bank without value being given, so that depositors are unsecured creditors of banks. In addition, many banking sectors are highly concentrated, so that the failure of one bank could easily lead to the failure of others through the collapse of the payments system. In order to ensure that public confidence is maintained, and to reduce the possibility of fraud and mismanagement, banks are generally licensed by a public body and their lending scrutinized either by a division of the central bank or a public agency, this scrutiny involving both the regular analysis of the structure of asset portfolios and inspection of advance control procedures.

2.2 The starting point and the nature of transition

At a high level of aggregation, the structure of the enterprise sectors at the start of transition in the formerly centrally planned economies varied from those of market economies of a comparable per capita income, or more generally those of a comparable level of economic development, in ways that reflected the preferences of planners and their strategy of "forced industrialization" and not those of sovereign consumers. Manufacturing industry was relatively large; employment in agriculture was relatively low and market oriented services such as trade accounted for only a small portion of economic activity. The effects of planners' preferences pervaded down to the most disaggregated level of individual products. Industries tended to be fairly concentrated, with a near absence of very small firms (see e.g. Brown, Ickes and Ryterman (1994)). This was perhaps inevitable given planners' responsibilities for coordinating production and pricing across sectors. Creating a relatively small number of large units simplified the planning process. In addition, planning isolated firms from product market competition, including foreign competition.

The physical capital of firms at the start of transition was similarly distorted. Fixed assets were often product-specific, with product specification and design reflecting planners' needs rather than market preferences. Working capital was relatively large, particularly as a result of high inventory holdings. Similarly, the development of human capital was guided to meet the needs of a planned rather than a market economy. For example, the absence of competition meant that there was no need to develop skills in marketing, while the incentive structure faced by managers tended to reward lobbying skills over more generally practical management skills. Lastly, productivity was low and much labour effectively redundant.

The organizational and physical characteristics just described are well known, but the effects of central planning upon financial structures are perhaps less so. Enterprise sectors started transition with a relatively low volume of debt in comparison with western firms, the ratio of debt to the book value of assets being of the order of 30 per cent, compared with the 60 per cent observed in western countries. Under central planning, enterprises held little bank debt. The state typically provided most fixed capital through budgetary transfers, so that bank lending together with trade credit was used primarily to finance working capital, principally receivables and inventories. Bank lending was also used by planners as a tool for monitoring firm activity. Consequently, enterprises at the start of the transition held little long-term debt, since most fixed capital was financed through equity.

We can consider transition in the enterprise sector to involve the construction of the three pillars listed above. Capital was socialized, diminishing greatly managers' incentives to improve enterprise performance, preventing the injection of private capital into enterprises and precluding the discipline of product market competition. Property rights were nowhere clearly defined and their assignation in security was not generally permitted. Commercial law was poorly developed, and the vast majority of enterprises were either state owned, or else enjoyed (implicit) state funding guarantees. Even where bankruptcy and workout procedures existed in law their use was extremely rare. Accounting standards were quite different from those adopted in market economies, but since the state was the owner of the enterprises, such information was neither widely disseminated nor used to monitor performance in the way that it would be in a market economy. Enterprises were expected to fulfil their production quotas under the central plan and banks were a control device of planners whose role was to monitor adherence to the plan within the agreed budget limits. The bias in favour of production in the planning process led to priority being given to meeting the output targets embodied within the plan over financial targets.

In market economies, owners and creditors have the responsibility for monitoring enterprise performance and providing private enterprises with strong incentives to respond efficiently to the environment that they confront. The process of transition, through the construction of the three pillars, leads to the development of an unplanned environment in which privately controlled enterprises undertake the production of goods and services. Managers become accountable to owners and creditors, who possess a variety of means of exercising control, including exit, dismissal and liquidation. The continuing need to generate income leads to managers being much more active than under central planning. Furthermore, they are required to develop a much wider range of skills. Market oriented enterprises have marketing functions and for these to be effective, the enterprise must be able to gather a wide range of data in order to identify market opportunities, addressing the needs of its potential customers through the development of products that meet those needs. Such a process implies the ability also to undertake research and development, a commitment to product quality implying a rigorous inspection regime, a sales division promoting the goods to customers, and cost accountants verifying that projects are profitable. All of this will be possible only if enterprises assist their employees in developing appropriate human capital as well as providing the organizational structures that facilitate the use of such capital. During the transition, then, the enterprise sector comes to be dominated by privately owned, market oriented institutions that tend to enter into long-term relationships based on trust and short-term ones based on contract.

The banking sector

Banks and bankers under central planning were caught in the gap between planners and enterprises. Simply being required to allocate directed credits, they lacked the autonomy to develop strategy and skills. We have noted that within market economies, banks are privately owned institutions, free to choose the projects that they wish to finance. In contrast, bank managers under socialism were little more than bureaucrats, their effectiveness being measured by their ability to assist in the implementation and monitoring of the central plan, while constraining the demands of state owned enterprises for funds. Under such a regime, banks' incentives to support production were strong, while incentives to ensure the efficient use of their funds were weak. In general, the plan dictated whether and when to advance funds and banks were little more than a conduit for advances, being required only to keep accounts. This failure to foster the skills required for market-based banking relationships was frequently exacerbated by governments establishing specialist banks that either financed particular sectors of the economy, notably agricultural banks, or else particular types of activity, particularly foreign trade. Such institutions proliferated in the 1980s and early 1990s when two-tier banking systems were established, with commercial banks frequently being created out of specialist divisions or regional offices of the state monobank. Specialist banks held portfolios that were much narrower than those that a full service bank would ordinarily wish to possess. Their monopoly of a particular class of lending has often made them important social partners, in transition increasing their ability to extract funds from government, and the attitudes of their managers has often reflected this culture. Agricultural banks exhibit particular problems in most countries, for they tend to regard themselves as providing non-budgetary support to rural areas. In particular their managers often consider that customers do not have an obligation to be regular in making loan repayments, and, tolerating a high rate of loan default, effectively provide an element of implicit subsidy through their lending. Such attitudes were quite pervasive among bankers appointed before transition. For example, the belief that a bank had a duty to support enterprises in order to ensure that jobs would be preserved was quite frequently expressed by Russian bankers.

By way of contrast, a bank manager within a market economy has to assess the likelihood of potential advance proposals being profitable, has to be able to monitor loan performance, needs to be able to propose action that borrowers should pursue, and is required to keep open exit routes (such as liquidation) as well as means of compelling creditors to change behaviour (such as workouts). Bank managers in market economies therefore require a wider range of skills than their counterparts in a centrally planned economy. They have to develop analytical skills as well as a basic understanding of management accounting and legal procedures. In addition, banks in market economies are required to develop management information systems that provide managers with regularly updated information on asset performance, specialist accounting and legal functions, central offices that oversee the behaviour of client managers, ensuring their adherence to prudential lending criteria, and debt workout departments that seek to resolve difficulties through more informal means than bankruptcy proceedings. In addition, as private corporations, banks are under constant pressure to provide a satisfactory return upon assets to owners. Assuming effective oversight by owners, such banks have strong incentives to reduce overhead costs, to introduce new products and to market existing ones more effectively. The transition within the banking sector may be characterized as the period of time during which new institutional structures emerge that provide banks with adequate incentives to reorganize their practices on principles of prudential lending. At the close of the transition, banks will be privately owned, market oriented institutions that respond quickly and appropriately to market signals.

Another way to describe the transition in this sector would be to say that it is the period of time during which the state withdraws from the direction of the business of banking, largely through the promotion of privatization. On this basis, transition is not a problem simply for the formerly centrally planned economies, but also one for a number of others. Within the European Union, Greece is a particularly interesting example, where there is still extensive state involvement in the direction of credit, most notably in the agricultural and development banks. These institutions could most politely be described as "weak" lenders that fail to scrutinize the quality of their lending adequately. It might however be rather more appropriate to consider them to be extensions of the appropriate ministry, engaged in the provision of off-budget subsidies to the industries that they finance.

2.3 Restructuring in the enterprise sector

(i) Adjustment by state owned firms

Transition means the retreat by the state from detailed micro-level direction of the economy. At the start of transition, the key policy measures with respect to the enterprise sector are price liberalization and the abolition of quantity planning – in other words, the introduction of product market competition. At the same time, firms remain stated owned, but the retreat by the state means that state owned firms are left, at least temporarily, in the hands of their managers and workers. These insiders have no formal ownership rights over the assets of the firm but very large control rights over the disposition of the cash flow (value added) generated by the firm. State owned enterprises (SOEs), at the start of transition, thus became insider controlled firms. In some countries, local government and industrial ministries also had some control rights.

The response of SOEs to price liberalization reflected this incentive structure. SOEs engaged in adjustment and restructuring measures because it was in the insiders' interest to do so. Should the firm sell more of its output or cease production of products for which demand no longer existed, the income generated would be at the disposal of the insiders; most obviously, it could be spent on wages. In contrast, reckless behaviour could result in the closure of the firm and the loss by insiders of the flow of income generated by the firm.

In the early transition period, after central planning was abandoned and prices liberalized, SOEs in both CEE and former Soviet Union countries responded by undertaking very basic restructuring measures, as is shown by both enterprise level surveys (e.g. Pinto et al. (1993)) and case study evidence (e.g. Carlin et al. (1995)). Such measures would typically include shedding excess labour, containing wage costs, changing the firm's product mix to stop producing goods which customers did not want to buy and to produce more of what customers did want, reduction in levels of inventories, and so forth. That SOEs throughout the region have been able to undertake simple restructuring measures is evident in aggregate economic data as well. For example, the absolute size of the downsizing of industrial employment in transition economies has been on the order of 30 per cent since the start of transition, a very large decline by any standard of comparison (table 2.3.1). The decrease in nearly all transition economies of the share of industry in employment is consistent with an adjustment in the direction of market economy "benchmarks"; the contraction of the oversized pre-transition industrial sectors means transition economies have industrial structures which are closer to those of market economies with similar income levels (EBRD (1997)).

TABLE 2.3.1

Change in total industrial employment in selected transition countries
(Per cent)

	Starting year	*Change after two years*	*Change after five years*
Armenia	1991	-20.9	-41.1
Azerbaijan	1991	-14.5	-25.7
Belarus	1991	-8.7	-26.0
Bulgaria	1989	-25.3	-42.7
Croatia	1991	-17.2	-28.3
Czech Republic	1989	-7.8	-20.0
Hungary	1989	-15.4	-41.5
Kazakhstan	1991	-16.4	-36.0
Kyrgyzstan	1991	-13.2	-42.1
Republic of Moldova	1991	-42.2	-59.9
Poland	1989	-6.3	-17.6
Romania	1990	-15.6	-32.0
Russian Federation	1991	-7.1	-25.2
Tajikistan	1991	-14.6	-35.8
Turkmenistan	1991	7.1	3.4
Ukraine	1991	-9.7	-30.4
Uzbekistan	1991	0.7	-12.8

Source: CIS Goskomstat; national sources; own calculations.

The introduction of simple cash management techniques by SOEs is worth noting in particular. In many transition countries, volumes of trade credit and overdue trade credit increased rapidly in the early transition period, prompting concerns that firms were rescuing each other. It now appears that these particular concerns were overstated. This point is best illustrated by a comparison with mature market economies, and by considering trends in trade credit over time. In general, both the total volume of trade credit and the volume of overdue trade credit in transition countries is comparable in scale with that observed in western economies – the equivalent of about 20-30 per cent and 10-15 per cent of GDP respectively (see box 2.3.1). Moreover, the scale of trade credit and overdue trade credit in transition countries has generally proved relatively stable at these levels. Current outstanding claims by firms on each other amount in aggregate to roughly three months of sales or less, which means that most other sales over the course of five to seven years of transition have been paid for. Payment discipline between firms in transition countries thus appears, in aggregate, to be comparable with that observed in western countries.

Box 2.3.1

The Hungarian bankruptcy framework

Prior to 1992, Hungarian bankruptcy legislation was based on the 1986 Bankruptcy Act, which had largely been designed to regulate the activities of state owned enterprises and was therefore not suited to an emerging market economy. The introduction of the 1992 Bankruptcy Act on 1 January 1992 was regarded as a reform that would induce a form of market discipline more akin to that in established market economies.

All legal entities were subject to the new Bankruptcy Act, which permitted three possible proceedings: reorganization (the reorganization of the enterprise whilst current management and/or owners remain in control); liquidation (under which control of the enterprise is passed to a liquidator whose responsibility is to attain the most satisfactory conclusion for the creditors of the firm, by restructuring the firm, selling off the assets of the firm piecemeal, or selling the firm itself as a going concern); and "final accounting" (voluntary winding-up of the firm). Whilst either the firm or its creditors were able to file for liquidation, only the firm itself could file for reorganization. Under reorganization proceedings a debtor firm has 90 days of protection from its creditors (which may be extended to 120 days if agreed by the debtor and its creditors) whilst it is negotiating a settlement with them.

The reorganization possibility included in the Act was intended to encourage debtors to establish plans for restructuring their business during the period of protection from its creditors, in a similar manner to that of Chapter 11 of the United States Bankruptcy Code, but within a limited time frame. The Act required the unanimous agreement of all creditors to any restructuring plan in reorganization, and if this could not be achieved within the grace period, the debtor firm was required to enter liquidation proceedings. Regardless of whether liquidation is entered via a failed reorganization or entered directly, the court appointed liquidator has two years to dispose of the assets in a manner which maximizes the return to creditors, subject to a debtor-priority list.

When the 1992 Act was being formulated, the Hungarian authorities were motivated in part by a concern that firms had soft budget constraints; they were particularly concerned about the apparent large volume of inter-enterprise arrears. Given that this perceived problem had prompted very few liquidations under the 1986 Act, the 1992 Act included an "automatic trigger". Under this rule a debtor firm that has credit owed to any individual or entity (such as suppliers, banks, tax authorities and so on) to any value outstanding for 90 days or more, was legally obliged to file for reorganization.

As the table below illustrates, however, the perceived problem of inter-enterprise arrears in Hungary was not actually a major problem. The stock of total trade credit in Hungary had been stable in the several years prior to the introduction of the new Bankruptcy Act, and the average overdue period in Hungary was less than one month, less than in many western market economies. The relatively few liquidation proceedings carried out under the terms of the 1986 Act can be readily explained by the lack of incentives of creditors to pursue liquidation. Seen in this light, the automatic trigger was peculiar in a number of respects: it did nothing to improve the incentives for creditors to file for liquidation of debtors, while at the same time it forced debtors to seek protection from creditors who were not threatening them.

Trade credit and overdue trade credit in Hungary, and selected west European countries, 1990

	Total trade credit receivables		*Overdue trade credit receivables*		
	Payment period (months)	*Per cent of annualized GDP*	*Per cent overdue*	*Overdue period (months)*	*Per cent of annualized GDP*
Austria	2.1	..	..	..	..
Canada	..	16	..	..	..
Denmark	1.6	..	40	0.7	..
Finland	1.8	20	45	0.8	9
France	3.5	38	44	1.6	17
Germany	1.6	..	38	0.6	..
Ireland	2.0	..	50	1.0	..
Italy	3.0	..	33	1.0	..
Japan	..	59	..	..	..
Netherlands	1.7	..	42	0.7	..
Norway	1.6	..	38	0.6	..
Sweden	1.6	21	38	0.6	8
Switzerland	2.0	..	50	1.0	..
United Kingdom	2.6	20	62	1.6	12
United States	..	17	..	..	..
Hungary					
1988	1.4	37	..	..	..
1989	1.3	35	..	..	..
1990	1.5	36	..	..	..
1991	1.7	35	47	0.8	17
1992	..	27	..	..	..

Source: Alfandari and Schaffer (1996).

Box 2.3.1 (concluded)

Following the introduction of the new Act, there were 4,300 bankruptcy filings between April 1992 and September 1993, of which 2,259 occurred in April 1992 alone. The number of liquidations also increased dramatically: there were 9,891 and 7,242 liquidation filings in 1992 and 1993 respectively. In September 1993, the automatic trigger mechanism was removed from the bankruptcy legislation and the requirement for unanimous creditor agreement to the proposed restructuring plan of the firm undergoing reorganization was eased. Under the amended legislation reorganization proceedings would no longer be initiated if a payment moratorium was supported by 51 per cent of creditors or more, whose claims amounted to at least 60 per cent of the total debts of the company. The result of these amendments has been the virtual disappearance of reorganizations in Hungary. Liquidations, however, continue to be numerous, running at a rate of 5,000-7,000 per annum.

The "automatic trigger" imposed a number of costs on the enterprise sector (Bonin and Schaffer (1998)). First, in addition to capturing unprofitable firms, it also captured, or threatened to capture, firms which were simply experiencing short-term liquidity problems, or were simply behaving in late payment practices comparable with their western counterparts. In particular, in 1992 real interest rates on bank credit were quite high, and the (artificial) discouragement of firms from using trade credit compounded the liquidity problems of the enterprise sector. Second, firms forced into reorganization suffered further liquidity problems because they had no access to credit during the reorganization process: no creditor would extend finance which would increase the debts of firms undergoing reorganization whilst those debts were themselves being renegotiated. Third, the large number of bankruptcy cases had an impact on the troubled Hungarian banking sector: firms in reorganization did not have to service or repay any debt during the 90 day grace period, and firms in liquidation had all their debt frozen for the entire duration of the liquidation procedure. Finally, the Bankruptcy Act imposed costs not only on the debtors that were forced into reorganization or liquidation, but on their creditors within the enterprise sector as well: 63 per cent of 200 medium and large Hungarian enterprises surveyed by the World Bank in early 1994 reported the loss of sales or suppliers as a result of being involved in bankruptcy proceedings as creditors.

As for the restructuring that resulted from these bankruptcies, the results of reorganizations differ from those of liquidations. Gray et al. (1996) found that reorganizations took place quickly, as specified by the Act, but that the content of agreed reorganization was typically fairly simple, involving measures such as rescheduling of debt and continuation of downsizing. Mitchell (1997) finds that many firms which went through a reorganization procedure found themselves in liquidation within several years. Liquidations took longer but involved deeper restructuring, including asset disposals and privatizations, and indeed Gray et al. report that in interviews, liquidators often described themselves as restructurers and privatizers. Importantly, the Hungarian liquidation framework encouraged firms in liquidation to continue to operate as going concerns. In contrast to the situation of firms in reorganization, new borrowing by firms undergoing liquidation was given seniority over pre-liquidation debts; thus these firms were able to continue to borrow, so facilitating the orderly liquidation of the firm as a going concern (Bonin and Schaffer 1998). The statutory remuneration scheme for liquidators, which paid them a percentage not only of the value of assets sold but also of the turnover of the firm, gave liquidators an incentive to keep their firms operating (Gray et al. (1996)). Bonin and Schaffer (1998) conclude that perhaps the most important lesson from the Hungarian bankruptcy experiment is that a reorganization procedure that protects the firm, and hence incumbent management, from creditors may be entirely unnecessary; a liquidation procedure that puts creditors in control, but also enables the firm to continue to operate during the liquidation, can work reasonably well even in a transition economy.

Enterprise level studies from a number of transition countries provide supporting evidence for the view that firms – both state owned as well as private – have learned to apply "financial discipline" towards each other. Firms typically introduce fairly basic methods of credit control which do not rely on underdeveloped institutions such as the bankruptcy courts: requiring customers to pay in advance or on delivery, refusing to supply customers who are behind on their payments unless the overdue debt is paid or renegotiated, and so forth. This behaviour by firms appears to have emerged fairly quickly after the start of transition. For state owned firms, it illustrates how such firms respond to the introduction of the forces of competition – faced with hard budget constraints, SOEs adjust, though not in a sophisticated fashion. We will return to this topic later, when we consider the behaviour of firms as creditors.

State ownership with insider control is, however, only an interim system. The main strategy for promoting enterprise restructuring in transition economies has been privatization. The experience of privatization has been very diverse across, and within, transition economies. A wide variety of privatization methods have been used and a correspondingly wide variety of ownership structures has emerged: mass privatization direct to members of the public or via financial intermediaries such as investment funds, sales or give-aways to managers and/or workers, direct sales to foreign investors, and so on. A survey of privatization strategies in transition countries would not be appropriate here. We note here only that, while many different techniques have been used, the usual approach has been to privatize firms with relatively little pre-privatization restructuring by the state authorities, and to leave the main tasks of restructuring to the new owners and financiers of the firms. There are several reasons for this.

First, the scale of the task facing privatizers was huge; had reformers used a western approach of thoroughly restructuring firms prior to privatization, the process would have taken decades or centuries to complete. Second, it is doubtful that state led restructuring of SOEs would have been very effective. The likely outcome would have been to repeat the inefficiencies, misallocations and rent-seeking of central planning. Third, rapid creation of a property-owning class and privately owned firms would generate a constituency for reform and a demand side for the legal and institutional reforms which are needed for good corporate governance and hence enterprise restructuring. Fourth, the system of state ownership in transition countries at the start of transition differed from that observed in market economies in that in market economies there is typically a much smaller number of large state owned firms subject to much closer supervision by state representatives. In transition countries, the much larger number of SOEs combined with the limited ability of the state to monitor the activity of enterprise insiders led to problems of asset stripping, spontaneous privatization, running down of SOEs by siphoning off profits, and so forth. (It is tempting to speculate here that the reason the Polish state sector has performed much better than that of other transition economies is because enterprise workers have been effective at monitoring management and at preventing this sort of activity in particular.)

(ii) Enterprise performance and ownership

Initial studies of the relationship between firm performance and ownership differentiated simply between state owned versus privatized firms. Evidence from both western and developing countries suggests that operating in a competitive market is not enough: private firms outperform state owned firms even in competitive industries (Vining and Boardman (1992)), and firm performance improves following privatization (Megginson et al. (1994)). The findings from comparisons of state owned and privatized firms in transition economies are similar – privatized firms perform better than their state owned counterparts. Current research is now focusing on relating differences in economic performance of privatized firms to differences in the identity of owners and structure of ownership, on the one hand, and on establishing the causality that leads from private ownership to better performance, on the other.

A useful starting point is the distinction between ownership and control of firms by workers, by managers, and by outsiders. In their study of worker ownership in transition economies, Earle and Estrin (1996), based on economic theory and empirical experience from other countries, identify a number of characteristics one might expect to find in worker owned firms. For example, worker owned firms would be expected to invest less than the model of a standard profit-maximizing firm would predict; they may find internal decision making cumbersome and inefficient; they will take longer to reduce overmanning; etc. On the positive side, worker owned firms might be expected to adjust more flexibly to, for example, financial distress because worker ownership might reduce worker-manager conflicts. (This last argument regarding worker ownership can also be applied to insider controlled state owned firms and, for example, their apparent wage flexibility.)

With respect to managerial ownership, Blasi and Schleifer (1996) suggest large-scale ownership of shares by managers of firms in transition economies will be associated with a number of problems. While share ownership by managers is often used to motivate managers in western companies, the scale of ownership needed for this is not very large. If managers hold large stakes in their (large) firms, then managerial risk aversion will lead to excessively cautious firm behaviour. Perhaps more important in the context of transition economies is that managers with controlling stakes in their own firms are the ones who decide whether they should stay in their jobs. The concern is that the introduction of new management into transition firms – new managerial human capital – will be slow in managerially controlled firms.

Identifying the effects of privatization on firm performance is hampered, however, by a reverse causality or endogeneity problem. Firms that are selected for privatization, or selected for a particular kind of privatization, are typically not selected purely randomly. In particular, their current or prospective performance may determine in part whether they are chosen for privatization, and the kind of privatization that takes place. To take a specific example, Earle and Estrin (1996) find that in a sample of 200-odd Polish firms, those that are employee owned perform moderately well. They suggest, however, that this result is driven in part by the Polish "liquidation privatization" programme, which allowed insiders to buy out firms and to borrow from the state to do this. In such circumstances, management and workers will choose to take their firm private only if it is worth it to do so, meaning that the firm has to have not only good long-term prospects (making it a good investment) but good short-term prospects (so it can generate enough cash to service the debt borrowed to purchase the firm). The causality in this example runs from performance to privatization, and not necessarily the other way around.

Evidence on the performance of state owned and privatized firms in transition economies is now starting to accumulate, and thus far the results have been broadly consistent with expectations, even when the reverse causality problem is addressed. For example, Claessens and Djankov (1997) examine the impact of privatization on firm performance using data on over 6,000 firms from seven CEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia) for the period 1992-1995. They find that following privatization, firm growth in total factor productivity increases by about 5 per cent per year. They address the endogeneity problem by controlling for the observed performance of firms in 1991. Earle and Estrin (1997), in a study of 400-odd Russian industrial firms in 1994, go deeper into the structure of ownership, distinguishing between state owned, managerially owned, employee owned, and outsider owned firms. They show that Russian firms that have been privatized to managers have restructured more and performed better compared not only with state owned firms, but also with firms that have been privatized with dominant worker ownership. Outsider private ownership, however, is associated with the most restructuring and the best performance. This study takes explicit account of the endogeneity of privatization and uses the econometric technique of instrumental variables to identify the causality that runs from category of ownership to firm performance. Other studies in this vein which have examined the relationship between ownership and performance while addressing the endogeneity problem are Frydman et al. (1997), Smith et al. (1997) and Roberts et al. (1998).

One question now being explored is what makes outsider ownership more effective than managerial, employee or state ownership. To take a simple example, we would expect foreign ownership to lead to deep restructuring and eventually strong performance because a (western) foreign firm brings advanced technical knowledge and deep pockets to the firm. That enterprise studies have not always found foreign owned firms to be strong performers may sometimes be explained by endogeneity problems, e.g. if insiders get the first option to take the firm private, the less attractive firms are what remain available for foreigners to buy.

The importance of concentrated share ownership and large blockholders has been examined by Claessens et al. (1997). They use a sample of approximately 300 listed Czech companies to show that firms with concentrated share ownership, and in particular firms which have large blocks of shares controlled by investment funds, are more profitable and have higher market valuations. This can be interpreted as evidence that ownership that is relatively concentrated, and concentrated in investment funds in particular, leads to better performance. These findings need to be interpreted with some caution, however, because of reverse causality problems; it is also possible that large investors such as investment funds are better at locating good investment opportunities, i.e. better performing firms.

A further study of the Czech privatization experience by Weiss and Nikitin (1998) uses the same data but reaches somewhat different conclusions. They find that share ownership concentrated in public entities and operating companies is associated with improved performance, but also that ownership concentrated in bank managed funds leads to worse performance than non-bank managed funds. Moreover, ownership concentrated in funds managed by investment companies is shown to have, at best, no effect, and possibly a negative effect, on firm performance. This latter result is qualified by the hypothesis that performance may be dependent on the nature of the investment fund. Weiss and Nikitin relate these findings to the fact that the investment funds established in the Czech Republic were closed-ended funds (around 70 per cent of citizens exchanged their vouchers for shares in closed-ended funds), in contrast to open-ended funds that are far more common in western market economies. They argue that the nature of closed-ended funds reduces the potential for shareholders to exert discipline upon fund managers, owing to the fact that shareholders are not permitted to redeem their shares, as is the case under the terms of open-ended funds. Instead shareholders may only sell their shares in the funds, and although such action may lower the value of shares in the fund, it will not act to discipline fund managers who generally chose to receive a share of the assets of their funds rather than a share of fund profits. Like the Claessens et al. (1997) paper, however, the Weiss and Nikitin study does not address the problem of endogeneity of ownership – different kinds of owners may have different effects on enterprise performance, or may differ in their selection of firms to own – and thus their results, too, must be treated with some caution.

The evidence of Barberis et al. (1996) sheds light on the importance of outside ownership in the selection of managers. They begin by asking whether it is enough for outside owners to give managers the right incentives for good performance, or whether the effectiveness of outside owners also operates via their role in replacing poor managers (e.g. those who found themselves managers of state owned firms because of their lobbying ability or connections) with good managers (who have the skills needed to get firms to perform well in a market environment). Using a survey of Russian shops following privatization, Barberis et al.(1996) show that simply privatization, and the introduction of high-powered incentives for managers, are not enough to cause shops to undertake major restructuring measures (engaging in major renovation, keeping longer hours, changing suppliers). Managerial turnover is also necessary for major restructuring to take place. Barberis et al. (1996) also use instrumental variables techniques to address the endogeneity of privatization.

These findings are confirmed by Claessens and Djankov (1998) in a study of 706 privatized Czech firms. This study presents empirical evidence which suggests that equity holdings by managers do not have a significant influence upon enterprise performance (where better performance is measured as increased enterprise profitability, labour productivity – value added per employee – and whether the firm established a marketing department after privatization). The importance of managerial turnover is highlighted by the finding that all performance indicators are negatively correlated with the length of tenure of the general manager of the enterprise. By disaggregating forms of managerial turnover it is also shown that managers introduced from outside the enterprise by private owners are found to improve all aspects of enterprise performance, whilst outside managers selected by the government perform less well, followed by internally promoted managers.

Such studies raise the question of whether, in the absence of new managerial talent and thus the potential for turnover, it is possible to retrain existing managers to improve performance. In this context Djankov (1998b) surveys 137 Moldovan manufacturing enterprises to examine whether there is supporting evidence for the hypothesis that training incumbent managers will lead to improved restructuring and performance. In doing so, care is taken to compensate for a potential self-selection endogeneity bias: engaging in training activities may simply reflect managerial type, as managers willing to undergo training may appreciate the worth of acquiring new skills and be more receptive to new ideas (i.e. are simply being better managers *ex ante*). The results of the econometric estimation presented show that enterprises in which managers have engaged in retraining benefit from substantial sales increases and conduct more restructuring.

This finding of the importance of new human capital, of entrepreneurial and other skills, in generating enterprise restructuring, is consistent with the results of studies of the new private sector. One of the stylized facts to emerge from the transition is the dynamism of the new private sector. Growth of new private firms is noticeable first in trade but then spreads to other sectors. In Poland, the country where the development of the new private sector is best documented, new private firms have driven the rapid growth of the manufacturing sector since 1992. Between 1992, when recovery started, and 1995, industrial output in Poland increased by one third, with the bulk of this increase accounted for by the new private sector (Gomulka (1997)).

Various reasons have been identified so far for the strong performance of the new private sector, though empirical evidence on their relative importance is still lacking. These firms have good corporate governance arrangements – private ownership, one owner or a small number of owners who are able to monitor the management closely (if they are not the management themselves). They are, by definition, new bundles of human capital set up by entrepreneurs.

Other reasons for the finding that new private firms are very dynamic include problems of sample selection and not necessarily properties inherent in these firms. The rate of turnover (entry and exit) is quite high in the small firm sector, leading to a survivorship bias in samples of new private firms – the firms which are included in the sample are "good firms", the "bad firms" having exited. The higher growth rates of these firms which this selection process generates nevertheless represents a genuine economic process – entry and exit – which contributes to economic growth. The industrial structure of communist economies left a large unfilled niche in the small- and medium-sized enterprise sector, which was naturally filled by new private firms. More generally, the entrepreneurs who have started these new private firms have been able to choose the sectors and locations in which they want to operate, and we would expect them to choose the more promising ones. State owned and privatized firms, on the other hand, inherited these characteristics. Some empirical studies of new private firms have tried to control for this last set of factors by controlling for size, location and industry when comparing new private firms with state owned and privatized firms (Konings et al. (1996) for Poland; Bilsen and Konings (1996) for Hungary, Bulgaria and Romania; Richter and Schaffer (1996) for Russia). These studies have found that new private firms are still more dynamic than state owned and privatized firms, though it is unclear if they have fully solved the sample bias problem.

We conclude this review by noting that more than product market competition, effective (outside) ownership and new management is needed; the overall policy and legal environment is an important determinant of economic performance in general. De Melo et al. (1996), for example, show that transition economies which have reformed the most – as measured by a "liberalization index" – have grown the fastest since the start of transition. Recent work is starting to explore the relationship between reform, or the lack of it, and enterprise performance. One line of work in particular has examined the role of government when government activity includes corrupt or rent-seeking activity, or, as Frye and Schleifer (1997) put it, when the "invisible hand" is replaced by the "grabbing hand". They show, for example, in a survey of Moscow and Warsaw shopowners, that Moscow shops are more likely to have been contacted by the racket in the six months (8 versus 39 per cent), are much more likely to need to accept a protection racket in order to operate (6 versus 76 per cent), faced longer waits to register their business (0.7 versus 2.7 months), faced more inspections from local officials, were hit with more fines from inspections, and so forth. The effect of such an economic environment is to reduce the incentive for firms to restructure and to drive profitable economic activity underground.

2.4 The banking sector in transition

Hungary and Poland took the first steps to separate banks from the state in the late 1980s, when they separated the commercial and central bank operations of the state monobanks. In Hungary, this was done by creating new banks that took over the assets of existing divisions of the monobanks, so that bank portfolios were concentrated by sector, while the Polish authorities established regionally-based state owned commercial banks. It might be argued that the creation of state owned commercial banks did not by itself change the incentives facing their managers, but this change gave these managers the opportunity to start to develop structures appropriate for the establishment of market oriented institutions.

However, although not the first to start the process, the boldest reforms took place in the Baltic states. Even prior to their achieving formal independence from the

Soviet Union, they established separate central and commercial banking institutions. Estonia moved particularly swiftly, permitting private control of a number of these banks early in 1990, with Latvia and Lithuania following in the next year. The Russian authorities also permitted the establishment of private institutions in 1990 and it is interesting to note that a number of private banks were formed by managers of state owned banks who had to do little more than assert their ownership rights over the property of the institution.

Progress towards privatization has been rather slower in other countries. Bulgaria, whose record of bank governance was exceptionally weak until 1996, first fragmented its monobank and then, finding that each unit was too small to be viable, had to undertake a measure of reconsolidation. As yet, it has not transferred the control of any of the state owned commercial banks to private hands. Similarly, Romania is only now planning to take this step. Poland's programme has stalled after the first three privatizations, partly due to concern that privatization was leading to the transfer of assets to foreign banks at large discounts to their actual value. In contrast, Hungary completed a programme in which foreign institutions took either controlling or strategic stakes (usually with the option to increase their holding later to take full control) in the largest six banks by the end of 1996. In the Czech Republic, stakes in the four principal commercial banks were offered to the public during the voucher privatization of 1993, although the national privatization fund remains the largest shareholder in all of them.

A commitment to privatization may be interpreted as a sign that a government is committed to the establishment of sound governance in the banking sector. However, there are good reasons, which will be discussed below, for not initiating privatization of the banking sector early in the transition, and certainly not until much of the enterprise sector has already been privatized. This suggests that there is likely to be a period during which the government is responsible for promoting governance in the banking sector. Since the business of banking relies upon selecting those customers who are capable of repaying their debts from ordinary business activity, it seems sensible for banks to avoid increasing exposure to customers who are likely to become insolvent. Recall that at the start of transition, most enterprises only held short-term debt at banks, which was used to finance working capital. In addition, the value of outstanding debts denominated in local currencies was quickly reduced because of the inflation that accompanied price liberalization. Most enterprises therefore had to negotiate new credit facilities early in the transition, permitting banks ample opportunities for the rebalancing of asset portfolios. Bonin and Schaffer (1998) and Schaffer (1998) show that as early as 1991-1992 Hungarian banks imposed hard budget constraints on loss-making firms, extending them less credit than was required for them to service and repay outstanding bank debt. This willingness of banks in the leading transition countries to reduce exposure to customers who were poor risks suggests that, in this respect at least, they responded to the new conditions under which they were trading quite early in the transition.

Government nervousness about rapid bank privatization is justified to some extent by noting that very early privatization is often associated with the collapse of the state and loss of control. Certainly, this outcome is typical of the states of the former Soviet Union. In these states, unless the emerging authorities were firmly opposed to reform, very rapid fragmentation of the monobank was quickly followed by the emergence of private institutions. However, the Czech Republic shows an alternative way of moving quickly towards a privatized banking sector, with the voucher privatization strengthening the position of the four largest domestic banks. With the exception of the foreign trade bank, these banks also emerged as major shareholders in large investment funds. Consequently, these institutions dominate a market in which there is limited competition. At a time when the banking industry in western Europe is undergoing consolidation that is likely to create networks spanning the whole of the European Union, it is not clear whether these comparatively small banks will be able to innovate rapidly enough to survive in their present form. Again, we note that the Polish case seems to involve an even more explicit attempt to create national champions. Banks were established initially on a regional basis and mergers are now being proposed that would lead to the establishment of a still smaller number of banks each of which would be the dominant bank in a particular region. Again, it seems questionable whether such banks will be able to maintain an independent existence for long. These considerations suggest that Hungary has been wise to import foreign capital and expertise, issues to which we shall return later.

In general, countries that tolerated early privatization of banks also tended to permit early entry of *ab initio* institutions into the banking sector. Again, we draw a distinction between fast reformers such as the Visegrad states who were clearly committed to market solutions, and slow reformers whose authorities failed to regulate the banking sector adequately, either because they were too weak, or because they failed to appreciate the need for special regulation of banking. In both cases, bank licensing tended to be exceptionally lax at the start of the transition. As a result, severely undercapitalized banks tended to emerge, particularly in Russia. These institutions quickly ran into a number of problems. In many cases, they were forced to lend principally to enterprises that were also only recently established, since (former) state owned enterprises had already established relations with (former) state owned commercial banks (SOCBs). The risks inherent in lending to new enterprises are such that failure of some of these banks was more or less inevitable. In the Czech Republic, where the government has a strong commitment to market solutions, the problems of small banks was such that the Konsolidacni Banka (KOB) was directed by the state to undertake refinancing of a number of small banks, relieving them of non-performing assets so that they might meet stricter capital adequacy criteria. The lesson here, and one that has been shown to work well in Romania, as we shall see below, is that it is possible to avoid difficulties in monitoring the performance of new institutions if entry is carefully regulated.

It is worth emphasizing that banks are unusual because they receive money from customers prior to delivery of goods or provision of value. The most spectacular example of this was not actually in a bank but in the Ponzi scheme run by the Russian "investment house", MMM, which showed the ease with which credulous investors could be separated from their money. Similar cases, such as Caritas in Romania and the pyramid schemes of Albania, show that the problem is potentially widespread. On a lesser scale, but using more sophisticated techniques, anecdotal evidence also provides several examples of investment funds in the Czech Republic engaging in fraud. The potential for such activity in these closed-ended investment funds results from the separation of ownership and control that we discussed above. Examples range from direct theft, for example, the sale of shares in the largest Czech department store (Kotva) by Tend Fund to a Cyprus company at a 90 per cent discount as reported in Weiss and Nikitin (1998), to cases of funds purchasing shares or other assets from dummy companies indirectly owned by the fund manager, at artificially inflated prices.

While smaller in absolute size than MMM, relative to the scale of the economy in which it operated, the collapse of the corrupt Banka Baltija in Latvia showed the damage that could be caused to an economy by the failure of a single institution. Weakness of regulation was particularly important in this case, where the discovery of irregularities in its activities led not to immediate closure, but rather to its gradual deflation. It is particularly interesting to note that as the bank collapsed, better informed investors, particularly from the enterprise sector, were the first to withdraw their money, so that private investors ended up bearing the bulk of the losses. Even in cases such as this where minimal regulation led to large losses, bank crisis can have beneficial consequences. In the Baltic states in particular, crisis led to the establishment of much more effective regulation, restricting entry and eliminating the weaker banks.

The Russian banking sector, where it has been estimated that approximately 500 delicensed banks were trading in early 1997, provides some interesting case studies. Many Russian banks appear to have been established in order to finance the activities of particular groups of enterprises, with the directors of the banks also being directors or associates of the directors of these creditor enterprises. Such cronyism, while not itself corrupt, certainly militates against these banks performing the proper scrutiny of advances. We note that where such banks are established, the enterprises establishing them frequently report either having had difficulties in obtaining credit from other banks, or else having been required to pay a high risk premium. The provision of finance at otherwise unobtainable terms has been found to be an important role of the banks at the centre of the Japanese *keiretsu* and Hoshi, Kashyap and Scharfstein (1990) show that banks provide support to group members that would not be made available to outside companies. While that research emphasizes the benign effects of group financing with groups providing a framework to facilitate workout of distressed companies, similar linkages have been held responsible for the recent collapse of the economies of South-East Asia. In those cases, systemic shocks have revealed a lack of liquidity within financial systems and this has led to bank failure.

However, it is important to distinguish between pocket banks, which are generally small in Russia and elsewhere, and financial-industrial groups, which are relatively large and more like the structures that emerged in South-East Asia. Pocket banks appear to have been a response to continuing government softness, in the form of the Central Bank of Russia allocating credits to enterprises through the banking sector, rather than through state agencies. Having control of a bank was the easiest way for an enterprise to ensure access to such funds. Furthermore, pocket banks could be very small, since Russian banking regulations permitted banks (until the end of 1997) to hold up to 60 per cent of their assets in loans to a single entity. On this reading, the question arises whether pocket banks are truly banks or merely highly devolved treasury departments for their parent enterprises.

Such an argument does not apply to the case of financial-industrial groups. These tend to be formed by banks, which have expanded with disconcerting rapidity. Salonen (1995) reports that it is ordinary practice for the banks to bring enterprises within their control by proposing to the managers of enterprises that they should not repay loans, but rather provide the bank with an equity stake in exchange for the debt. Given that equity valuations were very low early in transition and that they have subsequently increased in value very considerably during the stabilization of the economy, a number of these banks have been able to grow very rapidly, allowing them to continue adding to their activities. However, concern must remain that these institutions, which are in a number of cases dominated by entrepreneurs who seem to consider both a media outlet and a political party to be necessary to their business strategy, will not prove stable in the long run. There must be a concern that, having been established with minimal capital, the group increases its apparent value through very extensive lending within the group. As in South-East Asia, such groups are likely to remain financially stable only if their constituent enterprises continue to grow rapidly. Even a modest downturn in fortunes could lead to enterprises facing financial distress and being unable to meet interest payments as they fall due. In turn, the banks at the centre of the groups may then lack the reserves to enable them to meet their liabilities as they fall due, and so they too may fail.

We have already noted that commercial banks only appeared late in the period of central planning and there were few opportunities and incentives for individuals and enterprises to accumulate capital, with individuals typically having nowhere to turn other than the state savings bank. The existing SOCBs therefore not only lacked capital, but also lacked the means of raising it at the start of transition, even though the emergence of non-performing assets was causing rapid deterioration of balance sheets. Banks therefore had to rely upon governments to inject capital, except in the former Soviet Union, where inflation eroded both capital and claims. In the leading transition states of Poland, the Czech Republic and Hungary, such recapitalization took place in a number of programmes during the early 1990s. In general, these measures were intended to be general in nature rather than specific provisions against particular bad debts, so that it was not necessary for banks to identify specific cases in which they required assistance. An exception to this was the 1992 Hungarian loan consolidation programme, in which loans classified as non-performing as of late 1992 were removed from the balance sheets of the banks in exchange for government bonds. This was quite different from the purchase of the TOZ (perpetual inventory) loan portfolio undertaken by the Czech KOB in the same year, since these were purchased by the bank irrespective of the performance of the assets.

It is particularly instructive to compare the experiences of Bulgaria and Hungary in respect of bank recapitalization. Both have undertaken repeated phases of recapitalization, and Hungary has undertaken at least one round specifically intended to remove bad debts from the books of the banks, but although at first glance the two countries appeared to have acted in a similar way, Bulgaria entered into these programmes without giving banks any incentives to reform practice. Thus Dobrinsky, Dochev and Nikolov (1997) note that the best known case, the ZUNK law of 1994, placed no conditions on banks for participation in the programme. Furthermore, being the third such programme it indicated government tolerance of continuing flows of bad debt. Recapitalization therefore failed to resolve problems since banks continued to lend good money after bad. In Hungary, however, a bank privatization programme was being pursued aggressively at the same time that debt forgiveness and bank recapitalizations were taking place. Banks interpreted the establishment of this programme as marking the withdrawal of unconditional state support and indicating a need to perform effectively or else to risk failure. It might also be that the objective of privatization provides managers of banks with strong incentives to perform well, for if they are seen to be inefficient, the purchaser is likely to dismiss them, while if they are so inefficient that the bank cannot be privatized, then the state will dismiss them.

The withdrawal of the state from the direction of the banking sector necessitates the privatization of banks. As long as they remain under state ownership, banks are likely to continue to enjoy implicit state guarantees of liquidity and long-term financing. As the case of Greece has shown, such guarantees may also extend to banks in the private sector. Guarantees militate against the development of sound practice on the part of bank managers, perpetuating poor advance control procedures. Larger banks, whether state owned or private, will argue that their failure would be difficult for the economy to accommodate, but in general creditors would not be able to act against SOCBs in the way that such a bank seeking the reorganization of an enterprise in arrears might. Coupled with stringent reporting requirements, privatization would bring pressure from shareholders and creditors for banks to adopt principles of prudential lending.

Equally, however, privatization by itself is unlikely to be a sufficient basis for completion of the transition. Banks are unlikely to have sufficient incentives to adopt principles of prudential lending without the establishment of the three pillars to which we have alluded above. Banks will therefore require the buttressing of civil institutions, such as contract and bankruptcy law, company law, standard accounting practices and assignable property rights. Only when significant progress has been made in developing these will banks choose to seek access to the information necessary to discriminate among lending proposals, to monitor advances and to use market and judicial mechanisms to salvage the residual value from non-performing assets. We shall return to this issue below, but we note here that privatization is a once-and-for-all process, whereas the development of civil institutions is an ongoing one.

2.5 Bankruptcy, creditor passivity and enterprise restructuring programmes

(i) The role of bankruptcy in market economies

The mechanism of bankruptcy is a central mechanism in market economies for restructuring distressed firms. In this section we consider the nature of bankruptcy and its role in the process of restructuring firms in transition economies. We begin first with a caveat: bankruptcy procedures vary considerably within the developed western economies, and there is no generally accepted "best" bankruptcy procedure. Indeed, there is a long-running debate on bankruptcy reform in western countries (see e.g. the collection of papers in Bhandari and Weiss (1996)).

A bankruptcy framework enables an orderly settlement of debts when a firm is unable to pay its creditors. When a creditor extends finance to a firm, it expects to be paid, i.e. it obtains cash flow rights. If the firm fails to pay the creditor, the creditor has the option of taking legal action. If the loan is secured by some real asset of the firm, the creditor can move to take possession of that particular asset. In the case of liquidation, however, the creditor petitions the court for the firm itself to be wound up and its assets sold off (including possibly as a going concern), and the proceeds to be used to settle his/her claim and those of the other creditors of the firm. In order for this to happen, the control of the firm is taken from the firm's management and put in the hands of the creditors or an agent who will act on the creditors' behalf. A liquidation procedure can therefore be seen as enabling the transfer of control rights from the management to the creditors. The existence of these contingent property rights of creditors provides an important incentive for firms to pay their financiers.

Of course, such a procedure has implications for the other creditors of the firm. If claims were to be satisfied on a first-come, first-served basis, creditors would race to be the first to file for the firm's liquidation and an excessive number of bankruptcy filings would result. For this reason, liquidation is a collective procedure which typically freezes the debts of the firm and puts comparable creditors on an equal footing regardless of which creditor was actually the first to file for the firm to be wound up. Liquidation procedures furthermore specify the priority according to which the pre-liquidation debts are settled out of the returns from the disposal of the firm's assets – secured creditors before unsecured creditors, tax liabilities before (or after) other debts, etc. – as well as the procedures according to which decisions about the firm are made, including the role of any special administrator (the liquidator or receiver), and the bankruptcy judge him/herself.

Some bankruptcy frameworks allow firms to file with the court to obtain temporary protection from their creditors while they try to renegotiate their debts and introduce a restructuring plan. In contrast to a liquidation procedure, during such a reorganization the control of the firm remains with the existing management of the firm. The usefulness of having a "debtor-in-control" reorganization track alongside the basic "creditor-in-control" liquidation track has been much debated and is far from universally accepted. It can be argued, for example, that if the existing management of the firm is competent and the firm has restructuring potential, this would be recognized by the creditors or their agent in a liquidation procedure and the management retained while the firm is restructured. Reorganization can offer incompetent management a measure of protection from creditors seeking to assert their contingent property rights, and this in turn reduces the effectiveness of this disciplining factor on the firm's management outside of bankruptcy.

The efficiency of a bankruptcy procedure can be judged by how it allocates the assets of the firm, and at what cost. Roughly speaking, if the firm is most valuable as a going concern, it should be kept in operation and its debts renegotiated or paid off; if the assets of the firm are better employed elsewhere, the firm should be liquidated and the assets sold off, with the proceeds being used to settle the competing claims of creditors. Bankruptcy is therefore one way in which inefficient firms exit an industry. Consider, for example, a distressed firm which is making large profits before interest costs but is suffering large losses when debt service is taken into account. Such an enterprise suffers from a stock problem rather than a flow problem: it has acquired a burden of debt in the past, obligations that it cannot now meet. Were it able to reach an accommodation with its creditors, it could in principle begin trading profitably. However, an enterprise that makes operating losses – one which is not only financially distressed but economically distressed – cannot reach such an accommodation with its creditors as it will still remain unable to meet its obligations as they fall due. In such a case, the efficient outcome will be the liquidation of the firm and the disposal of its assets in more profitable alternative uses.

The case of Metallgesallschaft AG illustrates the nature of a stock problem very nicely. A highly profitable manufacturing company, it ran into difficulties in 1994 because of the behaviour of a trader in its derivative financial products subsidiary. The company therefore found itself facing claims that it could not meet as they fell due – indeed they were of such a scale that raising funds to meet them would have cost many years' profits. The company therefore sought protection from its creditors, reaching an accommodation with them that permitted it to continue trading. In such cases, this is an economically efficient outcome since the company possesses many assets, among them its own organizational structure, that cannot simply be liquidated to meet claims.

Bankruptcy has costs, only a part of which are direct costs such as payments to the court, to lawyers, bankruptcy officials, etc. White (1996) distinguishes between costs incurred during normal business operation of a firm, when future difficulties are not anticipated; after the onset of financial distress but before the start of bankruptcy; and during the bankruptcy process itself. An example of the first category is the "punishment effect"; the relative harshness of treatment towards managers of firms when they enter bankruptcy may elicit greater managerial effort so as to avoid having to enter bankruptcy in the first place. The second kind of costs arise because managers of firms in financial distress may have an incentive to engage in costly activity to try to stave of bankruptcy; for example, by trying to gamble the firm back into solvency through making very risky investments. The third category includes not just bankruptcy costs but costs such as liquidating a firm piecemeal when it is more valuable as a going concern, or allowing an inefficient firm to reorganize when its assets would be better deployed if they were sold off piecemeal.

Finally, the incentives for a creditor to file for the liquidation of a debtor may often be weak (White 1996). Secured creditors will often prefer to seize collateral rather than start a lengthy procedure involving other creditors. Unsecured creditors are often small and would find their direct costs of pursuing a bankruptcy procedure prohibitive, and being low on the priority list for the settlement of debts they may find their recovery rate to be small, especially if the firm has run down its assets or run up its debts by the time bankruptcy actually starts.

Indeed, White reports that recovery rates for unsecured creditors in the United States and Germany are on the order of 2-3 per cent. Given these inefficiencies and costs, it is not uncommon in western market economies for creditors to renegotiate their claims on their delinquent debtors outside a formal bankruptcy procedure.

(ii) Bankruptcy, creditor passivity and soft budget constraints in transition economies

In principle, the institution of bankruptcy has a number of features which suggest it could play an important role in the restructuring of troubled firms in transition economies. It is a decentralized procedure, relying on market mechanisms and incentives, and provides an orderly mechanism whereby the creditors of the firm are satisfied by the disposal of the assets of the firm, either through sale of the firm as a going concern or through a piecemeal sale of assets. Given that most distressed firms are state owned to begin with, this would mean bankruptcy would result in privatization.

In fact, bankruptcy procedures were rarely used in early transition, and even now are only gradually coming into use in the faster reformers. The reason for this is simply that creditors had, and often still have, only weak incentives to file for the liquidation of a debtor. First of all, transition economies start with weak legal systems. Enacting a modern bankruptcy law is just a first step and not itself a solution. The countries lack trained lawyers and judges, and corruption may be a problem. The absence of a body of precedent slows the legal proceedings, and makes it difficult for economic agents to predict the outcome of legal action. Delays in starting liquidation and introducing a representative of the creditors or court into the firm give the incumbent management opportunities for asset stripping. The inefficiency and unfriendliness of the legal system creates an obvious disincentive for creditors to use it to assert their contingent property rights, whether through the bankruptcy framework or by attempting to seize collateral.

Second, creditors file for liquidation based also on an assessment of the return to their claim, which in turn is based on the liquidation value of the firm. As already noted, transition economies start the transition with large declines in output and large numbers of financially distressed firms. Asset markets in early transition are very thin and the liquidation values of firms and their assets very low. The return to a creditor, even a secured creditor, from liquidation is liable to be very low. Third, a problem specific to banks as creditors is that pursuing a debtor into liquidation means the bank must recognize that the debt is bad and provision accordingly. If the bank does this on a large scale, it reveals its difficulties publicly, information it might otherwise wish to conceal. Fourth, creditors may delay filing for the liquidation of a debtor if it is possible that at some point in the future the debtor will be rescued by, for example, a government bailout. And of course, some of the disincentives for creditors to file for bankruptcy in market economies are also present in transition economies, e.g. the small size of many creditors' claims relative to the costs they would incur. The result of all these problems is the phenomenon that Mitchell (1993) has termed "creditor passivity": creditors in transition countries do not actively pursue their delinquent debtors via legal measures such as liquidation or seizure of secured assets.

Results from a World Bank sponsored survey of 50 Czech manufacturing firms in 1994 support the view that firms in transition economies are deterred from using the bankruptcy system by these factors. Of these firms, 80 per cent cited the existence of major obstacles to filing for the insolvency of a debtor firm that has not paid its debts. The most oft-cited reasons were the length of time a bankruptcy procedure would spend in the courts, the large debts and low liquidation values of debtor firms (making prospective recovery rates low), the uncertainty of the outcome, and in any case it was often easier to collect on the debt outside the court system using informal means (table 2.5.1). (The Czech government's decision to delay introduction of their bankruptcy law in the early 1990s out of fears about introducing a wave of bankruptcies would thus seem to have been unjustified.)

It is important to recognize here that widespread creditor passivity in transition economies is compatible with firms having hard budget constraints. Put another way, a profit-maximizing creditor may choose not to pursue a loss-making or distressed firm into liquidation because it simply does not pay to do so; and the creditor will not inject money into the debtor without expecting to be eventually repaid, for the very same reason. In such circumstances we could say that there is no flow problem – the creditor is not creating more bad debts by throwing good money after bad – but that there is a persistent stock problem.

The empirical evidence on whether creditors provide firms with soft budget constraints in transition economies is patchy but a picture is emerging (Schaffer (1998)). We can distinguish between three groups of creditors: suppliers (trade creditors); banks; and tax authorities (government). Roughly speaking, suppliers in transition economies usually present firms with hard budget constraints; banks sometimes do, more often in the leading transition economies; and one of the main mechanisms by which governments provide firms with soft budget constraints is by tolerating the accumulation of unpaid tax debts. The case of banks is discussed at length elsewhere in this paper; here we discuss trade credit and tax arrears.

As already argued earlier in this paper, both aggregate and enterprise level evidence support the view that trade creditors in transition countries do not typically provide their customers with soft budget constraints. Overdue trade credit has, however, been connected to soft budget constraints in a number of transition countries, via two distinct routes – but both of which can be said to derive from "soft" government.

TABLE 2.5.1

Survey of 50 Czech manufacturing firms in 1994
(Per cent)

"What are the main obstacles to filing for the insolvency of a debtor firm which has not paid you?" (maximum 5 responses)	*Per cent*
No major obstacles to filing	20
Major obstacles to filing	80
of which:	
Do not want to lose the debtor as a customer	26
Lengthy process through the courts	50
Legal costs are too high, qualified lawyers are hard to obtain	16
Uncertainty of outcome	38
Debtor firms are highly indebted and have many other creditors	46
Liquidation value of the debtor firm is low	38
Easier to collect on the debt outside the courts by informal means	36

Source: World Bank survey.

First, in some cases (e.g. Romania in 1991 and Russia in 1992), governments have responded to rapid increases in overdue trade credit, and accompanying political lobbying by firms, with "clearing operations". The aim of these operations was to net out, by administrative means and with the injection of credit, the mutual indebtedness of firms. Net creditor firms would be paid the value of their receivables net of the payables they owed to other firms; net debtor firms would receive credit to cover the amount they owed to other firms net of the receivables other firms owed to them. (The clearing scheme tried in the Czech Republic aimed to net out mutual debts unaccompanied by an injection of bank credit. Probably for this reason, very little mutual inter-enterprise debt was actually cleared in the Czech scheme (OECD (1994a)). These clearing operations did not succeed in "solving" the "inter-enterprise arrears" problem, since overdue trade credit subsequently re-emerged. As well as being inflationary, the clearing operations can be viewed as softening budget constraints since the credit injected went to net debtor firms. These schemes also reduced the incentives of firms to impose hard budget constraints on each other, since suppliers had less incentive to make sure their customers would pay them.

Second, there are specific examples of firms in transition countries which do not pay their bills for extended periods, but which for political reasons continue to be supplied. The best known examples are firms which do not pay their electricity bills but the electricity supplier cannot easily turn off the power. As in the previous case, the source of the "softness" is in the behaviour of governments rather than firms.

One of the main routes by which firms in transition countries have their budget constraints softened is through tax arrears, i.e. non-payment of accrued taxes. In contrast to the case of overdue trade credit, tax arrears in transition countries are large and growing; the flow of tax arrears has been estimated as varying from 1-3 per cent of GDP annually, and this is most likely an underestimate (Schaffer (1998)). Enterprise level studies have shown that tax arrears tend to be concentrated in loss-making firms. The most likely explanation for the tax authorities' toleration of tax arrears of distressed firms is that the fiscal return to pursuing the firm into liquidation will be low – these are highly indebted firms whose assets have a low market value – and the political cost will be high. By not paying their taxes, severely financially distressed firms are essentially able to extract a subsidy from the state – a clear case of the soft budget constraint.

Sometimes relatively healthy firms in transition countries have large tax arrears. Tax arrears in these cases are tolerated apparently because the firms are politically powerful and have either negotiated formal arrangements which allow them to defer payment of taxes or are simply powerful enough to delay payment. Russia provides well-documented examples of both cases. In 1994-1995, firms lobbied for a measure which allowed firms with wage arrears to defer, legally, payment of part of their taxes (in principle, in order to pay wages). This measure appears to have contributed both to the increase in wage arrears (so as to qualify for the scheme) and the increase in unpaid taxes, culminating in a tax revenue crisis of major proportions in 1996. The case of Gazprom, the giant, wealthy, and politically well-connected Russian gas monopoly, demonstrates how a powerful firm can extract this kind of subsidy from the state. That such a firm did not pay its taxes on time can be interpreted as saying that the cost of credit from alternative sources was higher than the cost of running tax arrears. This changed in early 1997, after the Russian government started taking strong measures to collect on tax arrears, and indeed Gazprom was able to become current in its tax payments in 1997 after finding alternative sources of credit.

(iii) Alternatives to bankruptcy

A bankruptcy framework is a necessary part of a market economy and hence its introduction is an integral part of the long-term transition to a market economy, but as we have seen it is not very effective at dealing with short-term, transition-specific problems. Large bad debt problems, both inherited and newly created, typically emerge during transition, but the absence of strong incentives for creditors to file for bankruptcy means widespread creditor passivity. "Stock problems", once they exist, can therefore persist for long periods. A number of unfortunate consequences follow: assets are not redeployed efficiently, overindebted firms cannot attract financing for viable projects, and the risk of lending is higher because lenders face greater downside risks and hence they charge higher real interest rates and set higher collateral requirements for borrowers.

A number of other approaches to dealing with the problem of restructuring highly indebted distressed firms have been tried, with mixed success. A key problem has been that government led programmes for restructuring troubled firms are often susceptible to being used to bail out firms rather than restructuring them – in other words, the restructuring programme becomes another route for soft budget constraints.

Hungary took the unusual, direct approach early in the transition of forcing thousands of firms to go through either liquidation or reorganization by means of a peculiar “automatic trigger”. The 1992 Bankruptcy Act required any firm with a debt of any size, overdue to anybody more than 90 days, to file for reorganization. We argue (see box 2.3.1) that the design of this feature of the bankruptcy framework was misguided in a number of respects – in particular, it was motivated in part by the belief that Hungary had an inter-enterprise arrears problem, and it required debtors to seek protection (by filing for reorganization) from creditors who were not threatening them in the first place – and that it proved costly for a number of reasons. The results in terms of restructuring of firms that went through the “debtor-in-control” reorganization track was disappointing, e.g. Gray et al. (1996) report that reorganization plans involved mostly simple measures such as rescheduling debts, and Mitchell (1997) finds that many firms that went through reorganizations subsequently filed for liquidation. Moreover, once the automatic trigger was abandoned, the reorganization track virtually disappeared from use. On the other hand, the “creditor-in-control” liquidation track appears to have worked reasonably well: there appears to have been considerable restructuring of firms that went through liquidation, and liquidation rapidly became an established and widely used procedure in Hungary. How much of an advantage this “kick start” brought depends on how much it speeded up the process of establishing the institution of bankruptcy; reorganizations and liquidations are growing in number in other transition economies, as experience accumulates and legal systems mature. Perhaps the main lesson from the Hungarian experience is that bankruptcy frameworks in transition economies do not obviously need “debtor-in-control” reorganization tracks that protect firms and their incumbent management; simply a “creditor-in-control” liquidation track is sufficient.

One approach used with some success has been to combine enterprise and bank restructuring in the same programme. The best known example is the Polish enterprise and bank restructuring programme, in which banks were given the task of leading the debt workouts of their bad borrowers, discussed in detail in box 2.5.1. Here we note that with respect to banks being “agents of change” in promoting enterprise restructuring, the programme has not entirely lived up to expectations, perhaps because it was essentially a debtor-in-control procedure. Empirical studies (e.g. Gray and Holle (1997); Belka and Krajewska (1997)) of the programme show that restructuring measures contained in the agreed plans are fairly simple and indeed, very similar to those contained in the restructuring programmes agreed in Hungarian bankruptcy reorganizations. The programme has worked quite smoothly, however, and further promoted long-term (deep) restructuring of firms by promoting privatization as one of the programme’s exit routes.

A different approach to the enterprise-bank bad debt problem has been to take the debt from the banks and give it to a specialized work out agency. Compared with the Polish approach, this trades off the loss of the bank’s specialized knowledge of the debtor with (hoped-for) benefits from concentrating workout expertise in a single institution. The danger is that the restructuring agency, being an agent of the state, will follow political objectives that slow rather than speed restructuring, e.g. with unconditional debt write-offs. This is naturally a greater danger in countries which are slower reformers. Examples where this approach seems to have worked moderately well are the Czech Republic (the Consolidation Bank, discussed in box 2.5.2), Hungary (where the Hungarian Investment and Development Bank was given a portion of the bad debt take from the banks, to work out or sell off, and did so) and Slovenia (where the Bank Restructuring Agency did this itself, achieving a 32 per cent recovery rate (OECD (1997), p. 75)). Examples where it has not worked well and where programmes proved costly and softened the pressure on firms to restructure are Bulgaria and Romania. It is reasonable to argue, based on these experiences, that given the choice between a centralized government scheme for restructuring firms, and no scheme at all, slow reformers would be better off taking the second option.

A particular kind of restructuring programme that is sometimes found in transition economies is a “financial isolation programme”. The motivation behind the introduction of financial isolation programmes in transition economies has been that there are a number of loss-making firms with payment arrears that continue to operate and are not being put into bankruptcy. Market forces, it is feared, are not providing financial discipline, and therefore it is desirable to “financially isolate” these firms from the rest of the economy and control their access to financing, while forcing restructuring measures on them. Our view, on the contrary, is that these arguments in favour of financial isolation programmes are misguided, on several grounds.

Box 2.5.1

The Polish bank and enterprise restructuring programme

Recognizing the desirability of its setting only strategic goals and avoiding direct involvement in the direction of details of enterprise restructuring, the Polish government introduced a legislative framework for enterprise and bank restructuring early in 1993. The framework was designed in such a way as to bring together banks and enterprises, encouraging them to work out the problems of non-performing assets in banks' balance sheets.

The programme had two purposes, one being the liquidation of enterprises that were inherently unprofitable. The other, which was more important, was a reduction in the debt burden of enterprises with potentially good prospects, which would accompany the writing-off of non-performing assets in the banking sector. The programme was therefore directed towards improving the financial state of enterprises that were making operating profits, but net losses through the cost of debt service. As well as providing these enterprises with a measure of financial comfort, the programme was also designed to promote restructuring and privatization plans since it was expected that part of the refinancing of enterprises, in some cases at least, would be the issue of new, privately held equity. The working out of problems of non-performing assets was intended to improve the liquidity of the banking sector, since final write-off of debts removed uncertainty over the potential exposure of banks to restructuring within the enterprise sector, eliminating the stock problem described in the text and improving the access of banks to external funds.

The programme established a vehicle for the efficient working out of these problems: bank conciliation. Enterprises were entitled to prepare a proposal for reorganization and to propose to their main bank that they should enter bank conciliation. Enterprises could only propose that conciliation take place and banks had the right to reject proposals. By insisting that only debtor enterprises could file for inclusion, the programme placed debtors firmly in control. Thus enterprises would only enter the programme and undertake reorganization if insiders approved, in contrast to the discussion of bankruptcy proceedings in the main text. To emphasize that this was purely a mechanism for working out problems associated with the transition, banks and enterprises were only permitted a period of three years, which concluded in March 1996, to enter the conciliation process, after which time the programme wound up as continuing cases came to a conclusion.

Conciliation therefore provided banks and enterprises with an opportunity to resolve their problems by mutual consent and without recourse to court involvement in restructuring. As van Wijnbergen (1997) notes, court led restructuring programmes, such as Chapter 11 reorganization in the United States, have a bias towards liquidation which tends to dissipate the institutional knowledge located within enterprises. The liquidation of poorly performing firms is often an extremely destructive step that destroys the surplus value created from the coordination of human and physical capital.

Liquidation is such a likely outcome in reorganizations because of the ranking of creditors. A junior creditor which stands to lose all of its claim in a planned reorganization might not stand to gain anything more in a liquidation. But if entering liquidation were to reduce the value of senior creditors' claims and junior creditors have a right to file for liquidation, then the junior creditors may threaten to make such a filing in order to try to persuade senior creditors to amend their plans and offer partial payment in respect of the junior creditors' claims. It is then possible for restructuring to fail because of the insistence of a single creditor upon better terms than those offered.

Conciliation was designed in such a way as to limit the opportunity for such behaviour. In general, the claims of creditors of Polish SOEs could be separated into three classes. The most senior claims were those of the tax authorities, generally in respect of unpaid social security taxes. Bank claims came second. Given the nature of central planning and the development of the banking sector, most Polish enterprises only had obligations to a single bank, reducing coordination problems considerably. The third set of claims were those of unsecured creditors and the last those of the state as the holder of equity in the enterprise. The tax authorities agreed to act simply as observers throughout the conciliation process, although they reserved the right to insist upon the priority of their claims where the final proposal seemed to be unviable. The tax authorities also agreed to match the debt write-off agreed by the other creditors, ensuring that those creditors had strong incentives to agree to write-off part of their claims, for by agreeing to such a reduction, all of the private creditors were able to recover a greater portion of their original claims than they would were they to insist upon liquidation. To reduce further the prospect of conciliation failing, on entering into the process enterprises were granted immunity from liquidation and bankruptcy proceedings for a period of nine months and conciliation required simply the approval of creditors holding half of the outstanding claims on the enterprise. In general this meant that any proposal was certain to be approved if it was acceptable to the bank and the tax authorities. Furthermore, dissatisfied creditors wishing to pursue bankruptcy were required to hold at least one fifth of outstanding claims, precluding most trade creditors from holding out by themselves.

Such reconciliation has been very widely used in the SOCBs. Data supplied by the Ministry of Finance suggest that of seven banks remaining under state ownership, nearly half by value of the loans that were classified in the initial audit of 1991 have been worked out under the auspices of the conciliation programme. In contrast, a further third of these loans were declassified as enterprises restructured and recommenced servicing their debts. Only an eighth of claims were resolved in court led processes of bankruptcy and liquidation. Considering instead the number of cases involved, approximately 1,200 loans were initially covered by the loan classification programme. Of these, van Wijnbergen (1997) reports that conciliation was applied in one sixth of cases while debt servicing resumed in approximately half of them, indicating that conciliation was strongly preferred when dealing with larger enterprises. Belka and Krajewska (1997) suggest that this might reflect the capacity of enterprises with considerable political leverage to be included in the programme irrespective of their likely future prospects and argue that it is possible to distinguish between such enterprises and those that possessed genuinely healthy prospects.

They also note that the Ministry of Privatization only agreed to debt/equity swaps in a small percentage of claims and that banks that undertook such swaps tended to have weaker balance sheets. Chudzik (1998) suggests that those banks which engaged in debt/equity swaps did so in order to encourage the firms to take credit from them in the future, rather than to ensure that reorganization took place. Furthermore, the low rate of privatization that therefore resulted might be considered to be one of the

Box 2.5.1 (concluded)

more disappointing outcomes of the programme, and the programme appears to have resulted in more debt rather than physical restructuring activity. Against this should be set the large number of cases where reconciliation almost certainly has prevented bankruptcy and the strengthening of banks' capacity to provide governance through scrutiny of debtors in the usual course of business. However, Chudzik (1998) also cites evidence that those debt/equity swaps and equity holdings by banks which did emerge have failed to improve enterprise performance and to encourage significant restructuring; therefore banks have not, as yet, succeeded in acting as "agents of change".

Box 2.5.2

Konsolidacni Banka – the Czech Consolidation Bank

Konsolidacni Banka (KOB) was established by the Ministry of Finance of the Czech and Slovak Federation in March 1991, and although granted an initial licence for only 125 days, it continues to operate today. Although often characterized by observers as a "hospital bank", KOB is both more, and less, than a repository for bad bank assets. Indeed, much of its initial portfolio was, strictly speaking, not "bad" at all.

As part of the recapitalization of the banking sector in 1991, KOB initially purchased Kcs 169 billion of perpetual inventory credits from the main domestic commercial banks (OECD (1991)). These TOZ (*Trvale se Obracejici Zasoby*) credits had been introduced in the 1970s as a mechanism intended to encourage improved enterprise performance by lowering equity holdings of enterprises and swapping for debt. TOZ credits were uncollateralized credits paying interest at a 6 per cent rate but had no maturity date; a further peculiarity was that despite their long-term nature they were used to finance working capital. Because of the increase in interest rates and liquidity squeeze felt by the enterprise sector in early 1991 in the CSFR, it was decided to transfer the TOZ credits to KOB, subjected to a revised interest rate capped at a maximum of 5 percentage points above the central bank's discount rate, and to give them a finite term of 8 years maturity. KOB was given the mandate to initiate necessary proceedings (including bankruptcy) in the event of non-payment. In terms of liabilities, KOB also inherited matching quantities of the commercial banks' liabilities to the central bank and deposits of the savings banks. Furthermore, in late 1992 KOB purchased "new block loans" in the form of non-performing loans from the domestic commercial banks with a face value of Kcs 12 billion at a 20 per cent discount (OECD (1996)).

As KOB was established as, and indeed remains, a bank under full state ownership, initial funding in early 1992 was received from an issue of Kcs 50 billion of National Property Fund (NPF) bonds (Kcs 5 billion, Kcs 30 billion and Kcs 15 billion from the Federal, Czech and Slovak NPFs respectively) (OECD (1991)). Following the breakup of the Czech and Slovak Federation, the KOB was divided into KOB, Prague and KOB, Bratislava at the end of 1992. Given that around 75 per cent of the inherited TOZ credits were to Czech subjects, KOB Prague (hereafter KOB) came to possess the lion's share of these. Furthermore, KOB received additional injections of funding from the Czech NPF which transferred bonds worth Kcs 3 billion in 1993, Kcs 30.8 billion in 1994 (transferred in two instalments) and an additional Kcs 15 billion in mid-1995 (OECD (1996)).

As just noted, the initial portfolio of KOB was composed entirely of TOZ loans, and they remain the largest category of asset of KOB. Although the quality of these credits was difficult to reliably assess when first acquired, they were not necessarily non-performing loans. Nor did the non-performing portion of KOB's portfolio (bad TOZ credits plus other qualified loans) make up the bulk of bad bank debt in the banking sector. At the end of 1994, about 40 per cent of KOB's loan portfolio was performing; and less than one quarter of bad debt in the banking sector was held by KOB (see table).

Non-performing loans in the Czech Republic
(Billion Czech koruny)

	1994	*1995*
KOB		
Total loans	76.2	73.1
of which: doubtful	46.3	48.4
Total assets	110.5	123.3
Entire banking sector		
Total loans	822.2	960.5
of which: doubtful	207.2	247.8

Source: KOB; OECD (1996); own calculations.

In 1994 KOB initiated its strategic plan to separate its stock of "old block loans" from "new block loans". The stock of "old block loans" accounted for 59.3 per cent of total KOB assets at the end of 1995, their value falling from CZK 80.1 billion in 1991 to CZK 63.8 billion at end-1995, and the bank engaged in the removal of insolvent clients from its portfolio (KOB (1995)). In addition the stock of new loans for medium- and long-term investment projects amounted to CZK 13.6 billion at the end of 1995. Financing has also been partly provided by KOB bond issues, the first of which occurred in May 1996 to the value of CZK 2 billion and a second, to the value of CZK 7 billion, in April 1997; in June 1997 both bond issues were placed on the main market of the Prague stock exchange (KOB (1997)).

Box 2.5.2 (concluded)

KOB began as a transitory institution set up to deal with a very specific medium-term problem, namely TOZ loans, but has evolved into an active and permanent "agent of the state" in the banking sector. Many of its major investment decisions now originate with the Czech government. In 1994 the Czech government instructed KOB to invest in AERO Holding and in Zetor a.s. Brno (a Czech tractor producer). These purchases were essentially rescue packages for troubled firms which most likely would not have been granted by the commercial banking sector using strict commercial criteria. Also in 1994 the government directed KOB to purchase shares in Czech Airlines held by Air France when Air France wanted to get out of this investment. In 1995 KOB began to enter into public provision investment projects and became a participant in a programme to modernize the rolling stock and lines of Czech railways, and in a project with PHARE and the European Investment Bank to construct motorways. In early 1996 the Czech National Bank put the failing Ekoagrobanka into forced administration and KOB became the main shareholder, whilst in autumn 1996 the government decreed that KOB should take part in two programmes, the first of which was intended to stabilize the smaller Czech banks, whereby KOB purchased the smaller banks' unprofitable shares, with the cost to be reimbursed from the NPF, and the second required the extension of credits to health insurance companies.

The successful restructuring of several KOB concerns such as Ekoagrobanka, which became financially viable in late 1996 and was sold by KOB to Union Banka a.s., and Zetor, which KOB began to sell in 1997, illustrates that KOB has the potential to make at least some government decreed investments profitable under suitable restructuring programmes. However, it is unclear whether KOB has sufficient incentives, and independence from political pressure, to ensure that tough restructuring measures are undertaken when necessary in government decreed projects. If not, extending finance to such projects could serve to soften the budget constraints of enterprises which would not have been granted finance under the application of commercial financial criteria, and could thus perpetuate the existence of loss-making firms.

To begin with, the existence of loss-making and arrears is insufficient evidence that creditors are providing soft finance. Firms can generate losses by virtue of not servicing their bank debt, for example, but so long as the banks are not injecting new money, we would say that the budget constraint is hard. And as noted earlier, the existence of stocks of trade credit in arrears is hardly conclusive evidence of soft budget constraints; they are common in western countries too, because firms in market economies typically pay each other late. More importantly, if indeed creditors are providing soft finance to loss-making firms, then the problem is not with the firms, the problem is with the creditors. We saw above that trade creditors in transition economies – firms – usually apply hard budget constraints towards each other, and that the sources of soft budget constraints in transition economies are usually banks or the government. Should either banks or government be soft creditors, the policy focus should be on bringing the banking sector under control, or on getting the government itself to stop bailing out firms. The danger with government run financial isolation programmes is that they can become a focus for lobbying by firms, and provide a means by which they can extract subsidies from the state.

The Romanian financial isolation programme of 1995-1997 ("Ordinance 13") provides a good example of these problems (Croitoru (1997); Djankov (1998a)). It aimed to impose financial isolation on a small number of loss-making firms with payment arrears; trade credit arrears were felt to be a particular problem. The plan was to require firms to submit restructuring plans and for the government's restructuring agency to choose to restructure or liquidate firms; restructuring could include "debt conciliation" i.e. reschedulings and write-offs. In fact, overdue trade credit was stable in Romania in 1994-1995 at the equivalent of 13-14 per cent (Schaffer (1998)); Romanian firms, like their counterparts in most transition countries, were imposing hard budget constraints on each other. Romania had bad bank debt problems, related primarily to insider lending by new banks (see below) and politically motivated lending, but the financial isolation programme addressed neither of these problems. A major source of soft budget constraints in Romania was the toleration of tax arrears by the government, but the programme made this problem worse rather than better as it facilitated the write-off of tax debts by the government. Indeed, when the programme was first announced, firms lobbied to get *on* the list of firms to be "isolated", expecting (correctly) that they would be able to benefit financially from inclusion. Finally, Djankov (1998a) shows that the programme had no positive restructuring results: firms in the programme showed no improvements in operational performance, nor did the programme speed up the privatization or liquidation of the firms it covered.

2.6 Managing the transition in the banking sector

We have already alluded to the fact that within the portfolios that banks carried over into the transition from the period of central planning a large stock of assets soon was revealed to be of very poor quality following the collapse of markets and the commencement of the process of adjustment in the enterprise sector. It might be thought that this would not have been a major problem, given that at the start of the transition, banks' debts were quite modest in comparison with the levels common in market economies and the value of their existing assets was often quickly reduced by the rapid inflation of the first years of the transition. However, banking involves continuing relationships and in order for their customers to continue trading, it was necessary for banks to continue to provide financing, particularly since most bank financing under central planning was short term. Within quite a short time, this stock of bad debts was found to be of the order of 20-40 per cent of assets.

Early in the transition, a significant part of the literature on the reform of the banking sector examined this problem, to some extent avoiding discussion of the problems of market orientation and institution building discussed in the preceding section. One early, influential paper, Begg and Portes (1993), recommended that governments provoke rapid bank reorganization by insisting upon full disclosure of the extent of non-performing assets. By inducing a liquidity crisis, a government might force banks to make full provision against bad debts. The government would assume responsibility for the inherited bad debts, while banks having received such assistance would thereafter be expected to accede to market disciplines. More importantly for our analysis, Begg and Portes introduced the important distinction between stock and flow problems, classifying enterprises according to their ability to meet existing commitments. They argue that enterprises making operating losses, being unable to meet existing liabilities, face a flow problem and should be liquidated, while those making operating profits, but which make net losses because of the cost of financing existing debt, face a stock problem and so should receive relief of those debts, while continuing to trade. For banks, this will mean a severe and rapid writing down of assets, and so as capital is utilized to meet the demands of operations, the entire banking system would face a liquidity crisis were there not adequate government support.

There are a number of questions that we wish to raise concerning this approach to the banking transition. Firstly, we would not have expected it to be possible to determine the “true” value of assets at the start of the transition. Accounting data, almost certainly, would have been inadequate to determine asset quality, while existing markets, particularly for industries dependent upon CMEA trade, contracted very rapidly at the same time as price liberalization was leading to inflation generally, but more importantly to rapid changes in relative prices. No bank would find it easy to determine the value of its loan portfolio in such circumstances, still less a bank undergoing transition that had never before had to assess asset quality. In addition, the capacity of enterprise management to meet the rapidly changing environment would have considerable effects upon banks’ asset quality, with effective management leading to the resolution of the flow problem through voluntary reorganization. Lastly, enterprises frequently survive only if their debtors continue to meet their obligations. By insisting upon the simultaneous liquidation of many enterprises and jeopardizing the value of such claims, the government might cause many otherwise viable enterprises to collapse.

However, the most serious source of misgiving is that this approach vests responsibility for resolving the stock and flow problems with the government. Even assuming that the recapitalization of the banking sector accompanying the universal debt write-off were to be followed by bank privatization, the process of “cleaning” balance sheets would involve extensive negotiation between bank managers and government officials, of the kind that took place under central planning. Bank managers have an interest in subverting such negotiations, wishing the government to treat a very large proportion of debts as included within the inherited stock in order to maximize the extent of the recapitalization. In such an exercise there would have been a grave danger of a serious double moral hazard problem developing, for it would have been very difficult, given the problems of valuing assets accurately, to ensure that the process would indeed be a once-and-for-all adjustment to market conditions. In addition, believing that recapitalization was likely to take place would have caused many enterprises to postpone reorganization, in the expectation that their debts with the bank would then have been written off, while banks would have avoided taking action to recover debt, knowing that the recapitalization was certain to cover their losses. Noting that the experience of transition has been that enterprises and banks have sought to participate in special workout schemes because they are seen to be ways of avoiding making difficult adjustments and to reinforce the authority of managers, such an outcome would almost certainly have resulted from any attempt to implement such a plan.

Adapting this idea that stock and flow problems might be treated differently, making a distinction between accounting and economic flows has been very helpful. We define accounting flows as the reported changes to assets over time and economic flows as actual changes to assets. Economic flows within the banking sector cannot actually be measured, but might be considered to be the value of assets were there liquid secondary markets for securitized debt into which they could be sold. Banks have considerable discretion, even in market economies with effective supervision, over the ways in which they treat the classification of assets. In transition economies, where central banks have only a rudimentary supervisory capacity, the freedom is even greater. The most well known methods of concealing debtor irregularity include the rolling-over of principal, the capitalization of interest and the variation of repayment terms. All of these actions can under certain circumstances be justified, but if used too widely the resulting divergence between economic and accounting flows has the effect of significantly increasing reported assets, suggesting that the bank has a stronger balance sheet than it actually does. The assumption that bank regulators are readily able to detect occurrences of such behaviour seems to be optimistic during transition when bank supervisors have only the most limited experience.

Again, permitting banks a degree of freedom in reporting their financial position need not be bad. If a bank that is technically insolvent, unable to meet all of its liabilities in an immediate liquidation, is still liquid, meeting liabilities that fall due timeously, then the regulator may prefer the bank to disguise its temporary insolvency by not classifying certain assets rather than declaring its position and entering immediately into liquidation. The bank may be able to recapitalize, or to trade back to solvency. By such means, the institutional capital of the bank is not dispersed in a final liquidation. Equally, it must be realized that when a bank is insolvent, but permitted to continue trading, there is a risk of the managers seeking to trade their way out of the situation through speculative dealing. In addition, it is possible that managers, realizing that the situation is untenable, will try to ensure that their own position is secure, even as the bank's worsens. Akerlof and Romer (1993) refer to managers "looting" the bank, using all means possible to divert the bank's resources to them. This could take quite legal forms, such as drawing a very large salary, or less proper ones, such as permitting the bank to purchase assets on the manager's behalf, shading eventually into fraudulent dealing on the manager's own account before the closure of the institution. Ponzi schemes, such as the one operated by MMM, represent the most extreme form of this behaviour.

We conclude that decentralized methods are necessary to resolve the flow problems faced by banks at the start of the transition, with banks themselves taking the initiative in resolving problems with debtors. Banks will only take on this responsibility if they do not believe that further government recapitalization is likely to be forthcoming and we have suggested that the most effective way of the government indicating its determination in this matter is to establish a privatization programme within the banking sector. Prior to privatization, managers of SOCBs will wish to signal their ability to potential purchasers by running the bank profitably and avoiding the creation of further bad debts. Once privatized, banks have even stronger incentives to stop further lending to insolvent enterprises, since the act of privatization has demonstrated the government's commitment to market solutions, presumably including tolerance of bank failure. However, bank privatization cannot easily be accomplished at the start of transition because of the presence of the stock of non-performing assets and so we turn to consider methods of resolving this problem.

(i) Stock problems: the role of government

Resolution of the stock problem must recognize that deterioration of asset quality generally takes some time. We have already touched on this matter in discussing some of the difficulties that would bedevil an overly rapid attempt to resolve this problem. Introducing further terminology, we refer to this gradual deterioration of asset quality over the first few years of the transition as the quasi-flow aspect of the stock problem. Were the future certain and bankers blessed with perfect foresight, then it would be possible for banks to make provision against the losses that they would incur at the very start of the transition when they assume liability for future losses. Facing great uncertainty, however, banks have to wait in order to determine the extent of debt quality deterioration before provisioning. This quasi-flow, the revelation of the extent of the stock problem, occurs as positions determined prior to the start of the transition unwind. Since this quasi-flow and the inherent stock problem have their sources in actions taken prior to the start of the transition, government action to resolve these should not cause problems of moral hazard in the way described above. However, it would be very difficult to disentangle the quasi-flow and the true flow elements in the deterioration of a bank's loan book, and so caution must be still be advised in dealing with this element.

By definition, the stock to which we are referring is simply a deadweight loss, a charge against assets in the books of banks in the transition economies. So long as these banks are liquid, its presence should not affect their short-term viability. For this reason, van Wijnbergen (1997) advocates that no action need be taken purely in order to resolve the stock problem. Instead, he suggests that early in the transition it is quite sufficient for government to recapitalize banks to maintain solvency. The decentralized solution sketched out above then resolves the remaining flow problem. Van Wijnbergen envisages only a general provisioning of the sort undertaken in Poland, Hungary and the Czech Republic, for recognizing the difficulties of distinguishing between stock and flow problems he recommends that the extent of the recapitalization should not be determined by loan quality, but rather by the need for continued liquidity in the banking sector.

(ii) Privatization as a policy objective

As already noted, very few governments have been able to restrict their interventions in the banking industry to a single recapitalization. Again, this need not be a problem, for the nature of transition provides a second opportunity to government to recapitalize banks, during which it can address the stock problem finally, yet still emphasize its commitment to market solutions. This occurs during privatization. Although it might be argued that during this process the government could effectively undertake the recapitalization by accepting a lower, possibly negative, price from the purchasers than it would receive for the recapitalized bank, the difference being the capital sum that has to be injected into the bank, it should be remembered that as the vendor the government probably has better information concerning the bank's prospects than the potential purchasers. It is well known in the presence of informational asymmetries market prices do not reach the level that they would under complete information. By completing the process of cleaning the balance sheet, the government removes one of the most important sources of uncertainty and increases the value of the assets to the purchasers. It should not be the primary aim of government policy to maximize revenues, but it may be very difficult politically to transfer assets to the private sector at significant discounts to asset value. Certainly, this has been the experience in Poland, where concern over the prices obtained by the government in the first bank privatizations has led to delay in implementing the remainder of the programme.

Privatization is a particularly useful mechanism for directing the development of the banking sector, for it limits the scope for government support, while committing the government most forcefully to the adoption of market solutions. In order for privatization to take place, it is necessary for the government to pass control rights over the bank to its managers and it will be necessary for the managers to demonstrate their basic competence. As noted above, ignoring this requirement in respect of new entrants in a number of the transition economies led to serious banking crises. It is therefore important for the banking regulator to be able to certify that banks prior to privatization have in place adequate systems for the scrutiny of lending proposals and the scrutiny of asset quality, minimizing the likelihood of continuing flow problems, and that they have made adequate provisioning for the existing stock of classified assets, so that, subject to the injection of further capital at the time of privatization, they are fully capitalized according to an appropriate risk-based adequacy schedule, which should be stricter than the BIS standards in recognition of the high volatility of the economy. Although such a regulator should be appointed by the government, it is important that the regulator is seen to be independent of the government and not subject to excessive political pressure.

Privatization should provide managers with strong incentives to improve performance. Their competence will be tested by the speed with which they satisfy the regulatory requirements for privatization. Poor managers who are incapable of implementing such measures should simply be dismissed, a step that was particularly effective in the case of MKB in Hungary. Good managers should be rewarded. Suitable incentive schemes might take account of the time that the bank takes to prepare itself for privatization. Indeed, it may be easiest to offer managers stakes in the bank at privatization, but to make the size of the stake contingent upon the speed with which the bank is privatized, so that the quicker privatization takes place, the greater the stake will be. Then by permitting only one privatization to take place at a time, managers are forced to compete against one another to maximize their returns.

Governments that leave recapitalization to the purchaser of a bank do not take explicit responsibility for resolving the stock problem, but rather adopt the legal doctrine of *caveat emptor*, finding buyers willing to purchase banks together with their stock problems. Assuming that banks have implemented the sort of reforms discussed above, then they will be capable of trading profitably and so their value net of the stock of inherited bad debts will certainly be positive and greater than their liquidation value. An argument can be made that the state, having created the stock problem through its use of central planning, has a responsibility to resolve it. However, such arguments draw on ethical, legal and political considerations and so lie well beyond the scope of this paper. Our rather more modest economic argument has been to note that the government finances a recapitalization either implicitly by accepting a low sale price, or explicitly through a formal recapitalization programme. However, in the presence of imperfect information, explicit resolution of the problem will maximize government revenues.

To some extent, this policy makes a virtue out of necessity. We have argued that it is best not to undertake a rapid recapitalization directed at the elimination of all bad debts, but that it is likely to be necessary to undertake a modest refinancing early on to maintain system liquidity. Early in the transition, extensive recapitalization is likely to exacerbate the flow problem if recapitalization is interpreted as a sign of government weakness rather than resolve. As new trading relationships are established and unviable enterprises revealed as being such, governments have an opportunity to strengthen regulatory capacity. It is only later that further recapitalization is advisable. This should be linked explicitly to the privatization process, and should follow immediately upon the stabilization of flow and quasi-flow problems. We wish to stress that we are not advocating that state ownership of banks should continue indefinitely, but rather merely claiming that the very rapid privatization and reorganization advocated early in the transition would not have been optimal. In particular, we consider that the process of adjustment in the leading transition countries has now progressed far enough that the privatization of any remaining state owned banks should proceed quickly. Should any bank require further support after privatization, the government should insist upon its finding it in capital markets, possibly in the form of capital injections by foreign institutions.

The need to wait for flow problems to be resolved and a regulatory framework to be established before moving to privatization brings out quite clearly the need for treating the enterprise and financial sectors differently. The provision of liquidity services and the payments system are joint products of the banking system, effectively being public goods. Essentially these "goods" are reputations, and as such are difficult to establish and easy to destroy. Furthermore, pervasive bank failure can have significant real effects, with the impact effect of some of the crises in the transition states exceeding 10 per cent of GDP as well as adversely affecting growth. In contrast to banks, which are intimately connected with all parts of the economy, individual enterprises can quickly be isolated by their creditors from the rest of the economy as soon as their performance starts to deteriorate. With certain exceptions, such as power transmission, railway and telecommunication networks, perfectly adequate substitutes exist for the goods and services that many enterprises produce and there is no significant public good aspect to their output. It scarcely matters whether the existing enterprise or some successor or alternative undertakes production. Efficiency can ordinarily be guaranteed by market processes and so privatization can proceed quickly. With banks, in the absence of internal restructuring and the development of sound prudential regulation, rapid privatization is most likely to be followed soon after by a damaging crisis, so that more attention must be paid to the establishment of institutions before embarking upon privatization.

This policy stance is quite unforgiving. It acknowledges the need for a grace period during which governments disentangle themselves from the errors of the past, but ensures that they remain firm enough in their dealings with banks to ensure that the economy passes through transition swiftly. Policy firmness is likely to be necessary, for not only are banks likely to be apparently insolvent at the start of the transition process, but they are also likely to make errors that lead to the accumulation of non-performing assets. Insisting upon purely market-based techniques may be politically difficult, yet necessary, if banks are to learn to discriminate between high and low quality proposals and to manage their portfolio. Learning requires the ability to recognize errors, possible only if the possibility of error is frequently present. This is certainly true in banking generally, and indeed it is noteworthy that the recent recession in the United Kingdom was preceded by a large credit expansion, which can be explained only if we assume that lenders expected continued growth. Poor judgement is therefore not simply an artefact of the transition, although lack of experience presumably exacerbated the initial problems that confronted banks.

2.7 Current issues

(i) Banks as agents of enterprise restructuring

It has sometimes been suggested that the skills that banks develop in resolving their own flow problems might be applicable in most enterprises, so that banks should take on the role of general enterprise restructurers within the transition economies. The claim is that where an enterprise is facing particular trading difficulties, its main bank, with which it already has a close relationship, is particularly well suited to providing managerial support and direction. The argument notes that central planning did not permit the development of other organizations that would undertake this function, so that banks, being the sole class of enterprises with experience of financial management, are the only potential agents of change. This might be seen as a particular problem in the general area of corporate governance and, as with the issue of whether or not to permit banks to own shares, the matter may depend upon the nature of the relationships between actors in the economy.

However, we consider that banks in transition are not generally equipped to direct restructuring. Just as the argument that governments are well placed to take the lead in restructuring ignores the extent to which governments directing central planning were responsible for the initial conditions of the transition, so advocates of bank leadership of restructuring ignore the reduced role of banks under central planning. Under socialism, banks were principally skilled bookkeepers, neither requiring nor developing the ability to appraise lending proposals and to monitor asset quality. That banks did not develop these abilities reflected less upon the quality of their managers and more upon the systemic failure to provide appropriate incentives. Recalling that at least in the leading transition economies, the changed incentive structure led to banks' managers staunching flow problems only a short time after the start of the transition, it would be unreasonable to claim that those managers needed external assistance simply because they failed to prevent the development of the quasi-flows at the same time. Equally then, it is unreasonable to attribute losses early in the transition to the quality of the managers in an enterprise or to the unviability of its product line. In at least some loss-making enterprises, it seems reasonable to expect a return to profitability after a suitable reorganization. Managers have experience of the industry and we consider that much of the human and institutional capital required to guide the transition at enterprise level will already be embodied in them. If bankers can be trusted to resolve flow problems within the banking sector because they are skilled in the business of banking, then other managers might also be expected to be able to transform the businesses that they direct. This seems to be more satisfactory than the competing claim that bankers are skilled in financial reorganization and so should be able to reorganize a wide range of enterprises. These considerations suggest that decentralization of the transition process should not simply mean vesting responsibility for its management in one group of managers, but rather in all of them.

Notwithstanding these comments, banks inevitably have a role to play in the governance of enterprises during restructuring. Under central planning, most credit was lent with a short maturity, so that during the transition period, particularly during the early stages when there was high inflation, enterprises had to return to banks to obtain fresh credit repeatedly. Banks were therefore intimately involved with the direction of enterprises. In the absence of capital markets at the start of transition, banks were not only the most important source of funding for enterprises, but also their most senior creditors after the tax authorities. For these reasons, banks are well placed to influence the direction of most enterprises, even if they are not suited to undertaking responsibility for most restructuring.

The issues of creditor passivity discussed above suggest that banks are unlikely to revert to legal procedures to force enterprise restructuring. Much more typical is bank behaviour within the Polish debt conciliation programme, discussed in box 2.5.1. Such procedures avert liquidation of enterprises where at least one component is viable, seeking to minimize the loss of institutional capital during the restructuring. The onus for reaching agreement lies with the principals, rather than being imposed by a court appointed official. In the Polish case, managers were given incentives to cooperate with restructuring and also to initiate business plans, since the conciliation period lasted only nine months after which creditors could sue for bankruptcy. By cooperating, managers had the opportunity to secure their own positions. In addition, the government agreed to write off its debt to the same extent as the bank. Since the government was the most senior creditor and the value of government and bank claims frequently exceeded the value of the firm's assets, writing down the value of its debt often resulted in the bank being able to increase the value of its claims. Furthermore, banks were able to convert debt into equity, effectively reducing the seniority of their outstanding claims, but offering the possibility of their recovering the value of foregone claims. Lastly, since conciliation took place in state owned enterprises, the issuing of equity to the bank effectively secured the privatization of the enterprise, another of the objectives of the programme. However, the programme can be accused of permitting the debtor considerable latitude, with many conciliations simply leading to the deferral of claims. This can be a problem particularly where the debtor has lobbied for inclusion in the programme, as appears to have occurred in a number of cases.

There is very little evidence on the role played by creditors in generating good performance in general, although there have been studies of bank behaviour looking at whether banks are more willing to invest in profitable firms. Pohl et al. (1997) study firms in seven CEE countries, examining the relationship between total factor productivity growth and net lending by banks to firms, defined as the increase in bank credit net of interest costs. They find a negative correlation early in transition that later becomes positive, and take this to be an indication that the quality of bank lending has improved through the region so that banks are lending more to firms with strong productivity growth. This interpretation is not the only possible one, since like the study of bank involvement in the ownership of Czech firms cited above, the direction of causality has not been established. It may be that increased investment funded by bank lending, possibly accompanied by increased bank involvement, has led to greater productivity growth, in which case banks have had a governance role. Equally, banks may simply have learned how to identify firms that were certain to grow rapidly, which would be consistent with a much more market-based approach to client relationships.

(ii) Banks as owners

Assuming that banks in the transition economies follow the behaviour of banks in market economies, then they will not seek to direct the management of enterprises in which they hold stakes. The literature suggests that with the exception of the *keiretsu* in Japan, banks in market economies tend to be passive lenders. Hoshi, Kashyap and Scharfstein (1990) argue that the banks at the centre of these groups tend to be more accommodating of firms that are in difficulty, and in particular that they are willing to organize a "lifeboat" to avoid bankruptcy. Furthermore, where a firm faces serious difficulties, the lead bank then takes a much more active managerial role, possibly seconding senior managers to oversee the direction of the troubled firm. Together with the evidence from Germany, this suggests that bank ownership of equity may be associated with a reluctance to use bankruptcy procedures. Given the current reluctance of banks to use such procedures, further weakening of the incentives to take recourse in such forms of discipline is possibly undesirable. An appropriate compromise exists in Hungary, where although it is possible for banks to swap debt for equity, banks can only hold such stakes for a period of 18 months. This is quite sensible, for it is a sufficiently long period of time for the bank to find purchasers of its stake, and so recover some of its losses, but a sufficiently short time period that the bank is unlikely to wish to do more than influence the direction of the company.

The financial enterprise groups in Russia discussed above are a particularly interesting example of banks that choose to hold equity stakes in enterprises. Most are created around a main bank, although Johnson (1997) argues that there is an important distinction to be made, with some groups being effectively created and directed by a single entrepreneur so that they are effectively conglomerates, and other looser industrial groupings, which seem to be defensive in nature, established to inhibit competition. Perotti and Gelfer (1997) provide a preliminary comparison of the effects of group membership on behaviour. They report that group enterprises appear to have lower cash holdings than non-group firms, that they have a higher investment to asset ratio, that they tend to be more profitable, but that this investment ratio appears to fall with enterprise profitability. In addition, the markets for equity in group enterprises appear to be less liquid than those for the equity of non-group enterprises. They interpret these findings as indicating that groups provide some liquidity services to their members, although they are unable to explain whether enterprises choose to join groups because they are less able to raise funds externally or whether once members of a group they have less need to do this. Lastly, they argue that the most illiquid of the group firms also tend to have high profits and low investment ratios, suggesting that they are cash cows for the groups.

This analysis emphasizes the value of groups. Against this rather generous appraisal, we note that these groups are also led by entrepreneurs who have been very successful in acquiring heavily discounted assets, so that they amass great wealth very quickly. Such entrepreneurs are likely to view groups principally as vehicles for self-aggrandisement and therefore to consider that they exist in order to enrich them personally, weakening governance considerably. Comparison with the rather more collegiate *keiretsu* may therefore be rather misplaced, particularly in view of the difficulties that family owned groups in countries of

South-East Asia have continued to experience during the past year. As already noted, if the bank at the centre of any group is illiquid, then the group is likely to become unstable quite quickly if the enterprises forming the group experience a sudden downturn.

(iii) Entry *ab initio*

The preceding discussion has largely been concerned with issues relating to banks established under the period of socialism. However, as already noted, certain important issues in the transition relate to the development of new domestic banks. There are no good reasons for a complete ban on the establishment of such institutions and those that are advanced are generally intended to protect existing institutions from healthy competition even if this would retard the transition. The most persuasive argument is that new institutions, lacking the burden of past debts, may well be able to offer finer spreads than the existing ones who have to earn income to cover their anticipated losses. This suggests that new entrants are likely to displace the existing banks by choosing to lend only to the best prospects in the enterprise sector, possibly concentrating on lending to enterprises founded *ab initio*. However, given the risks of undertaking such lending, this outcome is most unlikely and has not occurred in any transition economy with the possible exception of the Baltic states.

The absence of private capital accumulation, together with the absence of effective equity markets, prevented the launch of new, large-scale institutions at the start of the transition. Domestic banks could then only be established with a very small initial capital, and so could only engage in limited lending. While some new private enterprises grow very rapidly, many, perhaps even the majority, fail. Lending to such enterprises particularly if they are unable to offer good security against advances is inherently risky, even in market economies and so is frequently undertaken only by specialist venture capital institutions. Banks in the transition economies had no experience of lending to new ventures and so could not easily hire staff possessing the skills necessary to identify large numbers of potentially successful enterprises. Whereas an existing institution can risk some of its capital in engaging in such activities without significant risk to its survival, the same cannot be true of new entrants.

In discussing the nature of policy in respect of existing banks, we argued that banks have to be given incentives to adopt sound principles of lending, particularly through the commitment to privatization. In addition, however, we noted that minimum capital adequacy standards are required in order to reduce the risk of banks becoming illiquid. There is perhaps an argument that the risks that small *ab initio* institutions face are so much greater than those faced by established banks that they should have to meet more stringent capital adequacy standards, but there is again a danger of discrimination here that would lead to the inefficient protection of the existing institutions. Instead, following Anderson et al. (1996), we consider it more appropriate to set a high level of minimum capital that an institution seeking to be registered as a bank must possess. Very high capital requirements need only be a temporary measure, but at the start of transition when bank supervisors may not be able to withdraw licences and liquidate banks, it is probably the most effective way of preventing numerous small, badly managed banks from setting up in business. Should a few weak or corrupt institutions manage to establish themselves, the regulatory burden will be much smaller, and as noted in the accompanying box 2.7.1 in the case of Romania, the problems are likely to be manageable even when regulation is rudimentary. It is interesting to note, however, that countries that had difficulties resulting from the collapse of *ab initio* institutions tended to permit entry without insisting upon adequate capitalization initially and that having had such an experience have adopted more stringent capital adequacy standards.

We have already discussed the problems of pocket banks that are established in order to provide advances to particular groups of enterprises. Typically founded with very limited capital, they remain stable only for as long as the groups that they are financing continue to grow. High initial capital and capital adequacy requirements would certainly reduce the risks attendant upon this form of entry, but effective regulation should identify those institutions whose assets largely take the form of loans to a single group of enterprises, and licences should be revoked in such cases. In addition, there is a clear need to ensure that loans to directors or companies with which directors are associated are made on ordinary commercial criteria, in particular ensuring that repayment terms follow ordinary commercial practice. Verifying that such conditions are met requires a degree of sophistication on the part of the regulatory system that has probably not yet developed in many transition economies, suggesting that it is still appropriate to rely in many cases upon the cruder methods of control noted already.

The problem just identified certainly becomes much more serious when the bank is corrupt, and cases where bank crises have been triggered by the collapse of one or more such institution have been observed, notably in Latvia following the collapse of Banka Baltija. Here, there is possibly less that the bank regulators can be expected to do, since the object of the owners of the bank in such cases is to defraud their customers. As the cases of Bank of Credit and Commerce International and Barings Bank in the United Kingdom remind us, detecting fraud can be very difficult if the management of a bank are either willing to ignore it or complicit in it. There is a need for governments to establish the *bona fides* of entrants to the banking sector and to satisfy themselves with regard to their competence both prior to the granting of a licence and in order for the licence to be continued. However, it is just possible that some countries have been too strict in administering their licensing regimes. An important part of the process of learning how market economies

Box 2.7.1

Bank failure in transition economies – a comparison of the Czech Republic, Latvia and Romania

The initial periods of transition frequently resulted in a rapid increase in the number of banking institutions, by way of fragmentation of previously state owned banks (in some cases combined with privatization), and new bank formation. Unfortunately, such was the pace of bank formation that it frequently exceeded that of legislative and supervisory progress in the banking sector. The Czech Republic and Latvia provide examples where this process culminated in significant bank failures. In contrast, the Romanian National Bank implemented a stricter licensing approach that limited the number of new banks entering the financial sector in the early stages of transition.

By the end of 1992 the total number of licensed Czech banks stood at 45, whilst Latvia (a nation with around one quarter the population of the Czech Republic) had 61 licensed banks by the end of 1993. This rapid increase was made possible not only by lax licensing requirements, but also by virtue of the extremely low minimum capital requirements and reduced capital adequacy ratios which were applied by the Czech and Latvian central banks (for example, although the Czech Republic now applies Basle Committee capital adequacy requirements, at the end of 1990 capital adequacy ratios were set at 5 and 1.5 per cent for new and established banks respectively).

In both Latvia and the Czech Republic, inexperience of staff at the new banks undoubtedly contributed to the prevalence of inappropriate lending behaviour, and this was exacerbated by the fact that new private banks were often confined to dealing with *ab initio* private enterprises, with no history upon which to judge performance and prospects, and little or no collateral. In addition, as opening a bank provided a cheaper source of funding than borrowing from existing banks, a number of pocket banks emerged which were owned by one or more enterprises. Hence the new banking sectors became typified by dubious lending, in some cases outright fraud, and eventually bank failure.

The Czech central bank took control of its first bank in October 1993. As the problems within the banking sector became increasingly apparent, a further 11 banks failed or had their licences suspended, representing around 8 per cent of total assets of the banking sector. The Latvian banking crisis was largely provoked by the failure of the largest commercial bank, Bank Baltija, which was finally placed in the hands of a liquidator in April 1996. Concerns over Bank Baltija first arose in March 1995 when the bank refused the central bank's invitation to produce financial statements audited in accordance with international standards, and would not permit auditors full access to relevant documentation. This refusal raised concern over the financial security of the bank, with the result that enterprises and households rapidly withdrew their deposits (the speed with which rumours and bad news concerning banks provoke responses from the depositors is notable for a transition economy). Upon further investigation Bank Baltija was found to have a negative net worth of $320 million (around 7 per cent of Latvia's expected GDP for 1995), and central bank officials began negotiations with the owners and management of the bank. As owners and managers delayed negotiations it was alleged that in April 1995 Bank Baltija sold around 50 per cent of its loan portfolio (about $80 million) to the Russian Interbank, a Moscow-based pocket bank, in return for Russian government bonds equivalent to 29 per cent of the par value of the loans sold — and these bonds were never received. Once Bank Baltija was finally placed in the hands of liquidators, several other banks failed including the Latvian Deposit Bank, Centra Bank and Olypija Bank. By the end of the crisis around 40 per cent of the assets and liabilities of the Latvian banking sector had been compromised (about $900 million).

In contrast, bank failure in Romania has been confined to two banks: Credit Bank and Dacia Felix. These banks were among the first to be established in Romania in 1991 and were the first two private banks to be licensed by the Romanian central bank. Each bank began with a high proportion of state owned enterprise ownership, but diluted their state owned enterprise share to become mostly private by 1994. The banks grew rapidly in the first few years of operation. By the autumn of 1995 it was clear that the banks were experiencing difficulties and further investigation revealed mass insider lending. The Romanian central bank reacted by starting bankruptcy procedures against the banks, but progress through the Romanian courts was extremely slow. After more than a year of delays the central bank changed strategy and withdrew the licences of the banks in 1997 (yet this was also challenged and delayed).

Despite these two cases, large-scale bank failure has been avoided in Romania by virtue of the fact that the central bank has chosen a strategy of aiming to limit entry of new banks to a small number of well-capitalized banks. With the introduction of a two-tier banking system in Romania in April 1991, the Romanian central bank introduced a host of requirements ensuring that criteria such as the Basle standard and exposure rules akin to those of the EU were adopted. Minimum starting capital requirements have been kept fairly high and licensing strictly regulated and limited. As of 1996, Romania had 29 licensed banks (including foreign owned banks) compared with 50 in the Czech Republic (a country with less than half the population). The result is that, despite the handicaps caused by the slow pace of reform in Romania – notably the difficulties the central bank has had with the judicial system in exercising its regulatory authority – the Romanian central bank has been able to perform its supervisory functions fairly effectively, and the problem of new bank failure has, so far, been largely contained.

function must be that commercial entities are allowed to fail and so there is much to commend setting regulatory standards so that the weakest banks fail, with arrangements being made to ensure that the industry avoids the likely subsequent loss of confidence in it. We note that in market economies, the problem of individual bank failures is not usually a matter for direct government intervention, but for the central bank acting in concert with other, soundly based institutions.

Lastly, we review a number of recent proposals for the improved regulation of banks. It is increasing apparent, as more and more countries liberalize financial markets, that immediately subsequent to deregulation the risk of bank crisis is very high. The removal of repressive conditions leads to increased financial intermediation, the entry of new institutions and the development of new trading patterns. Honohan (1997) seeks to establish the reasons for such fragile systems experiencing crisis. Among the measures that he considers are limits to the rate of credit expansion, although he regards this as being unsatisfactory, since such limits are likely to be avoided through new forms of disintermediation. In addition, we must question whether there is any evidence of the difficulties in transition economies being the result of excessive credit flows.

Similarly, we consider universal deposit insurance to be an initially attractive proposal that has serious defects. As argued by Akerlof and Romer (1993), such schemes erode all incentives to avoid bank failure. Publicly provided insurance removes the incentive for depositors to assess the risk of losing money, not only permits, but encourages, the managers of a bank to engage in gambling activities, knowing that they will not be liable for any losses, and meets losses from a pool provided by taxpayers, so that even regulators have no strong incentive to value the risk of failure correctly. We consider firstly that insurance cover should only be partial, particularly for larger depositors, noting that in the United Kingdom, public liability for deposits is restricted to 90 per cent of the deposit, up to a limit of £20,000. In addition, we consider that it may be appropriate for further coverage to be provided by the banking industry itself through a mutual insurance fund. This seems particularly important, since it will ensure that there is sharing of information concerning performance, so that premia can easily be adjusted to the risk of the business being undertaken. Furthermore, through their participation in the payments system, banks have continuing relations with one another and this further reduces the risk of moral hazard developing.

However, such schemes would be difficult to implement in certain transition economies. For this reason, we are particularly struck by the proposal of Hellman, Murdock and Stiglitz (1998) to complement minimal capital requirements with an upper limit on deposit rates. Again, they are concerned that deposit insurance promotes risk taking on the part of banks, but argue that by choosing a cap that is rather less than the refinancing rate for banks that prudent banks will maximize franchise value by offering an interest rate lower than the cap. The cap therefore serves the purpose of preventing excessive competition for deposits, eliminating the gains to gambling. This is a striking result, and with the attractive feature for transition economies that imposing a deposit rate ceiling requires little in the way of regulatory capacity. We do not, however, recommend implementing this measure as yet, partly because its novelty ensures that no government has yet sought to implement such a policy and partly because it is a theoretical result that may not take account of certain important aspects of the transition economy. In particular, it does not consider whether there would be distortions to the market resulting from the holding by existing banks of stocks of non-performing assets and it fails to provide guidance as to the appropriate level for the deposit rate cap. Were the cap set at a very low level, then this might guarantee profits for the existing banks, inhibiting new entry and retarding the development of the banking sector.

(iv) Foreign institutions

Foreign institutions have an important role to play in the development of financial markets in the transition economies. Banks with experience of operating in market economies can participate in transition economies either directly, by opening subsidiary offices, or else indirectly in a number of ways, ranging from entering into contracts to provide training in the use of systems through strategic alliances with existing banks to the acquisition of a (majority) stake in a bank. In certain cases, foreign banks have found it difficult to obtain licences to operate subsidiaries because local authorities are concerned to protect the position of domestic banks as they work through the problems of transition. However, where licences have been granted, the penetration of foreign banks has not been exceptionally high, in part because they do not have well established branch networks or reputations within these economies. In many ways, therefore, the opportunity to take a stake in an existing bank appears to provide most banks with a more satisfactory route to enter a transition economy.

A domestically owned banking sector is not necessary in the transition countries. Given the lack of capital in the banking sector, and the difficulty in developing institutional capital of the sort discussed already, it is quite reasonable for governments to seek out equity partners or willing purchasers after the resolution of the stock problem discussed above. Such partners would be able to provide knowledge of banking procedures used in market economies, notably in the scrutiny of advances and the treatment of non-performing assets. Being much more deeply capitalized than the domestic banking sector, they would be able to absorb the losses resulting from the misallocation of credits much more easily than the domestic market. Such a strategy is perhaps particularly appropriate to the banking sector, given the strategic nature of individual institutions, but should again probably not be attempted early in the transition since there would then be difficulties in valuing the asset portfolio of individual banks.

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Discussion of chapter 2

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It is a pleasure for me to discuss a paper that is not only very rich in content, but also rich in non-stereotypical statements. The paper is full of knowledge accumulated over many years of investigating transition in numerous countries, so that everything in it is based solidly on empirical research. That is why it is hard to contest the principal hypotheses; but it is also good because it provokes new questions and new lines of research. I will make just a few observations on some of the three pillars that Mark Schaffer and his co-authors refer to in their analysis.

The first concerns the process of adjusting or reforming state owned enterprises before their privatization. I agree with what has been said, that such adjustment is basically contingent upon hard budget constraints and sound macroeconomic policies. But at this stage, it is also usually a defensive or shallow adjustment, as opposed to the strategic or deep adjustment which is brought about by privatization. I would like to mention one additional factor that is quite important, namely, the *prospects* for privatization: the clearer are the prospects for privatization, and this holds for state owned banks as well as SOEs, the more motivated will be the management of the SOEs to go forward with the more painful and more meaningful steps required to restructure the firm.

The second observation that comes to my mind concerns the question of privatization versus restructuring, or the time sequence of privatization and restructuring, and I fully agree that the state, or the state structure, is not the most conducive source of restructuring. Generally, the state has proved to be a rather inefficient agent for restructuring, not only at the enterprise level but also at the sectoral level. Our Polish experience is full of empty declarations by the government to conduct sectoral industrial policies. Where the state, or policy makers, had in mind a "crisis-management" type of structural policy, then the picture is somewhat mixed. But where they had in mind a "picking-the-winner" type of industrial policy, then the result is a clear failure – I may add, fortunately.

Observation number three is about the link between ownership and economic performance. Here I must say that at the beginning of the transition, when it was still very difficult, if not impossible, to carry out, a lot of economic research tried to prove how much better private firms were than the state owned firms – and it was done in vain, basically because it was too early, and Mark Schaffer signals this in the paper. Over time this kind of reasoning virtually disappeared, maybe because it became evident that private firms were investing more, and were more export oriented. Although again, this is a more intuitive rather than a statistically based truth.

However, what is more important now is that privatization seems to be needed because private firms are (i) more stable than state owned enterprises, less prone to political vagaries, and (ii) they are more open to novelties, to innovation, and also, a kind of quasi-political argument which comes to the forefront, because rent-seeking is less probable with private firms. An additional argument, which applies in a country like Poland, but also in the Czech Republic and Hungary and, let us say, the first wave of EU applicants for whom the negotiations are coming closer, is that we feel, or the policy makers feel, that the state should get itself out of the trouble of restructuring and hand it to the private sector, since privatization seems to be the more natural way of seeking solutions to problems which are difficult to solve, and perhaps impossible for the state to solve. What is more important now is to compare the subsequent performance of different forms of privatization: insider versus outsider privatization, management dominated or employee dominated, the latter typical for Poland but not so much for Russia, for example. What I think could have been better described or more deeply investigated in the paper is the impact of corporate governance structures. One of the most interesting issues to be followed and investigated in the coming years is how the Czechs will disentangle the corporate governance problems that have arisen in the wake of voucher privatization.

My last observation is on a very interesting statement made in the paper, about bank privatization, namely, the optimal moment for bank privatization to occur. The paper argues that it is probably better for the transition economies to wait a bit with bank privatization: this may very well be true, but the argument that there is a danger of private banks being too harsh or overly restrictive with borrowers is not confirmed by the Polish experience. Two Polish banks were privatized early on in the privatization programme and their behaviour was not different from all the others which had not been privatized, but which, nevertheless, had a clear prospect of being privatized in the coming years. Maybe this does not prove very much, but I think this interesting statement in the paper underlines the need for more insight into this question.

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First, I would like to say that generally I agree with the conclusions of the paper, and the description of the transition process I consider to be comprehensive enough. Nevertheless, I will try to add some details and to provide some alternative views on some issues that will tend to reflect the situation in Slovakia rather than the general one in all transition economies.

The paper reaches its aim of describing the processes of restructuring the banks and enterprises in transition countries and identifying possible future policy problems. It not only brings original ideas to the subject but also *provides a very good overview of the relevant literature.*

In the introduction to the paper, "large-scale schemes" for transitions seem to some extent to be put in opposition to the "greatest possible decentralization of problem solving". Of course, there has always been a debate as to which of these ways is better. However, it seems to me that the two approaches are not necessarily in contradiction during the transition process. While dedicated government is needed to launch the reforms at the beginning of the transition process, in the later stages market forces should be increasingly used in solving problems. Here we can quote Czech Prime Minister Vaclav Klaus who said that during the initial period of transition politicians are heroes, while later on, the heroes become entrepreneurs.

A more precise definition of "restructuring" would be welcome: different experts have different explanations in terms of the scope of this expression, as well as in terms of the subjects to be restructured. Namely, does restructuring mean changing anything in the firm, an industry, or a whole economy, including labour shedding, changing trade partners, replacing managers, adopting new strategies, new investments, etc.? Is it an effort to maximize profits, market share or stability? I would recommend a definition similar to the following one: micro-restructuring refers to all changes at the micro-level which lead to maximization of society's welfare in the medium term.

The paper identifies very well the nature of the management of firms under socialism, particularly by noting the lack of incentives for managers to raise productive efficiency – instead they created benefits for themselves by manipulating the planning system.

The basic steps in restructuring taken by enterprises in the early stages of the transition consist of "shedding excess labour, changing the firm product mix, reduction of level of inventories, etc.". Basic restructuring measures are thus properly identified, as are the main conditions for them to take place at all, namely the abandonment of central planning and the introduction of price liberalization. However, here, a clear division between the various phases of restructuring could probably help to describe the whole process. For example, in the EBRD's *Transition Report 1995* the following division was used:

- *reactive restructuring* – referring to immediate changes caused by outside forces (for example labour shedding);
- *strategic restructuring* – meaning changes in market orientation (for example reorientation of exports from east to west); and
- *deep restructuring* – for example, new investments.

It is argued in the paper that as far as comparisons among firms privatized in different ways (direct sales to managers, outsiders versus employees, voucher schemes, etc.) are concerned, the results are not clear, since the firms were not selected "purely randomly". One can agree with this statement insofar as any analysis can always be successfully questioned. But I think that even such comparisons say something valuable. Moreover, one should take into account that in the early stages of the transition, there was no information about future prospects of enterprises. One of the top economists in Slovakia, in the early 1990s, stated that Slovakia should have totally abandoned the electronic industry and car production, since foreign competition was very strong. Now, both industries are doing relatively well. This example shows that at the start of transition there was no reliable information about the future prospects of Slovak enterprises and thus, in fact, they were chosen to a large extent "randomly".

The three pillars necessary to form joint stock corporations are described very well. However, the reality in my country, at least, shows that a number of very prosaic conditions should also be fulfilled as well: economic agents have to acquire experience through the process of learning-by-doing (as is stressed in the paper) and the initial and fundamental political conflicts have to be settled. This problem seems to be generally underestimated in the transition economies. Even the best institutional framework may fail, and often does, because of a lack of experience. As far as the political battle is concerned, only limited restructuring can take place before the ownership relations are settled ("*inter arma silent musae*"): the insiders – incumbent managers clearly determined to stay in their positions – have often preferred to manage or own worse enterprises than being employed in better firms. The process of privatization, a reluctance to create capital markets, as well as a willingness to postpone bankruptcies, exemplified the priorities of the strongest interest groups.

The difference between banks and enterprises described in the paper is a good reason for analysing both groups separately. For similar reasons it might be helpful to analyse natural monopolies and utilities separately as well.

There is also good justification for special regulation of banks. It might be added that another reason for regulation is that the creditors of banks – the depositors – are usually not concentrated and thus have little incentive to monitor and control banks' behaviour as shareholders normally do.

The starting point of the transition is described very well. However, in the sentence "... product specification and design reflecting planners' needs rather than market preferences" I would recommend, on the basis of my experience, replacing "planners" by something like "nomenclature". The rationale for this is that the plan was not simply an order from the centre, but rather the result of bargaining between "planners" and managers. For example, in the former Czechoslovakia there was a piece of legislation forcing all firms to supply the market with consumption goods to the equivalent of at least 1 per cent of their production. That was a result of a total victory of managers over planners: firms simply produced for production not for citizens (just as the victory of artists can be called "*L'art pour l'art*").

Among the initial policy reforms, price liberalization and the abolition of quantity planning are rightly mentioned. But perhaps foreign trade liberalization should be mentioned as well, since a number of firms redirected their exports and imports from former CMEA countries to western ones.

As is stated in the paper, "Enterprises have learned how to apply 'financial discipline' towards each other". *Thus, it can be agreed that the total volume of the overdue trade credit in transition economies and developed ones is comparable.* However, one should take into account that various alternatives to bankruptcy procedure have their own costs. Beyond requiring payments in advance, and refusing to supply customers who are behind on their payments, we can mention using illegal leveraging of payments (which undermines credibility of the whole economy, the allocation of resources in the economy being far from optimal), and executing secured loans by executions which can destroy firms which only have stock problems.

Barberis et al. are quoted in the paper when arguing that privatization and the introduction of high-powered incentives for managers are not enough to undertake restructuring measures. The example of Russian shops was used. Here, one might mention that shops traditionally, at least in my country, have been considered as a leading part of the black economy. Therefore, firstly, even during socialism they were in some sense privately owned, and, secondly, it is hard to measure the level of restructuring when the economy of a firm cannot be monitored. Nevertheless, one should agree that privatization is definitely not enough to accomplish successful restructuring.

CHAPTER 3

BANKING SECTOR REFORM IN THE TRANSITION ECONOMIES – A CENTRAL BANKING PERSPECTIVE

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3.1 The relevance of the topic

Banking sector reform cannot be seen in isolation from the broader question of financial sector reform. The financial sector itself is based on three pillars: the payment and settlement system, financial institutions and financial markets.[58] Developments in the banking sector and any reform of the existing structure should thus ensure that these three pillars remain sound.

The OECD stated recently that the creation of transparent, flexible financial systems open to worldwide capital flows is essential if underdeveloped countries are to achieve strong economic growth in the years ahead.[59] The EBRD[60] summarizes the key elements as follows: "The weaknesses in banking systems in transition economies stem from a combination of legacies of bad loans, political interference and lack of skills and capital, with large macroeconomic shocks resulting from rapid disinflation and remonetization. Most countries of the region have not so far been affected by systemic crises on account of the relatively small role played by financial intermediation in their economies, although most have experienced a process of bank consolidation as regulatory frameworks have been tightened. However, the establishment of sound banking principles and appropriate bank supervision has far to go. The financial sector weaknesses in the region hold more potential upsets in store for both forecasters and policy makers".

The OECD proposes aiming for a flexible and open domestic financial system to underpin growth. The EBRD clearly identifies the typical immanent weakness of the domestic financial system in economies in transition. Both these topics, the *relationship between a stable financial system and growth and the system-immanent weaknesses in the banking sector*, are relevant for this paper.

Most central banks are charged with some responsibility in the area of financial system stability. If bank restructuring is to lead to a sounder banking system, then central banks will be involved and perhaps asked to play an active role in this process. For example, in a February 1998 lecture, the Governor of the Bank of England, Mr. George, clearly stated that the bank's second core purpose was the maintenance of financial stability. As put recently in more general terms by Mr. White, the Economic Adviser of the BIS: "Weak financial systems can have long-lasting and insidious macroeconomic implications (the problem of "financial fragility") that are naturally of concern to central bankers".[61]

From an international perspective it should be clear that the role of the BIS is to share the central banks' concerns about financial stability. It is one of the world's leading institutions in promoting financial stability, particularly strengthening banking supervision and payment and settlement systems. Recently, in a joint initiative with the Basle Committee on Banking Supervision, the BIS established an Institute for Financial Stability, which will respond to the increasing demands for assistance in implementing sound principles and policies in all areas bearing on financial stability.[62] The role played by individual international organizations in strengthening financial systems was detailed in the Report of the Working Party on Financial Stability in Emerging Market Economies released in April 1997 by the Group of Ten.[63]

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[58] This structure is standard. More recently, finance theory has placed more emphasis on, *inter alia*, the proper incentive structure for financial agents, risks in all markets, instruments, balance sheet items and the "CIA" (contracts, information and agents). The main question is what drives the financial system. See, for example, Bisignano (1995), Berthelemy and Varoudakis (1996) and Crockett (1996).

[59] OECD (1997c).

[60] EBRD (1997).

[61] White (1998).

[62] "The BIS Institute will be engaged in three principal activities: the organization of high-level seminars directed at key policy making officials in central banks and supervisory agencies; the provision of training on a regional basis for groups of senior officials that implement policies; and acting as a clearing house for the co-ordination and provision of technical assistance by central banks and supervisory bodies." BIS, *Press Communiqué*, 12 March 1998.

[63] The constituent members of this Group of Ten Working Party attest to the broad approach taken in the strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems: representatives from the finance ministries and central banks of industrial and emerging economies and from the Basle Committee on Banking Supervision, the International Accounting Standards Committee, the Bank for International Settlements, the European Commission, the International Monetary Fund, the Organization for Economic Co-operation and Development and the International Bank for Reconstruction and Development (World Bank).

The role of the BIS in particular was outlined in a recent paper by its Economic Adviser. What is of concern to central banks worldwide is naturally of concern to the BIS as the coordinator of central banks' cooperative efforts. The topic of this paper – "Banking sector reform in the transition economies" – is therefore very much germane to the concerns of central banks and particularly of the BIS.[64] In the final analysis, however, it is the responsibility of the national government and the financial authorities in each individual country to develop and ensure financial stability domestically.

3.2 Some major caveats[65]

What do we mean by bank restructuring? The concept does not only apply to rebuilding after a crisis. There should be continuous efforts to monitor and strengthen the financial sector, paying due respect to the ever changing economic and financial environment.[66]

(i) Interdependence, comprehensiveness and complexity

What is important to note at the outset is that whatever will lead to a strengthening of the banking system will not occur in a vacuum or in isolation. This implies that the macro- and micro-environment will have to be taken into account[67] when assessing bank restructuring and, equally importantly, interdependencies between the various economic reforms. One aspect of this complexity is captured by the literature on the sequencing of reforms.[68] The notion of interdependencies also leads to the acceptance of the concept of the comprehensiveness of the approach taken, be it in terms of the legal framework or of financial (including banking) supervision.

My second preliminary remark is that one should not underestimate the complexity of the problems involved. This is clearly indicated by the above quotations from the EBRD and OECD. It is also reflected in the fact that the integration of the financial block in economic modelling, on theoretical as well as empirical grounds, remains largely elusive. There is, for example, comparatively little work on the inclusion of the banking systems' intermediation function in growth frameworks.[69]

(ii) Eastern Europe – a diverse group of countries

What is probably a less contentious statement is that central and eastern Europe is by no means a homogeneous area as far as domestic banking systems[70] are concerned. This is perhaps an obvious observation but certainly needs reiterating and indeed is borne out by the fact that most conferences or books on this area include country studies, an approach which is also reflected in the structure of this Seminar. This implies, *inter alia*, that more general statements on particular developments for a range of countries may be somewhat contentious from an individual country perspective. On the other hand, one could probably agree that other countries' experiences provide useful insights and guidance in the quest for a balanced, stable, efficient and secure financial system.

(iii) Sound banking – a vision emerging

The importance of a sound banking system has come under scrutiny of late, a situation unfortunately exacerbated by the Mexican and more recently the Asian crisis. There now appears to be much more agreement on the broad principles than ever before.[71] The broadest framework is found in a milestone paper by the Group of Ten.[72] That paper's stylized list of the major elements to be considered on the road to financial stability is reproduced here as an annex. "Sound" in this context means that a systemic collapse is not very likely. It is the risk of contagion which is the major reason for official involvement, in one form or another, in the regulation and protection of the financial industry.[73] Of course, individual banks should still be able to go bankrupt. But to find the delicate balance between eliminating unsound banks and ensuring the continued soundness of the rest of the financial system is perhaps the most challenging task.

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[64] White (1998) outlines the BIS's important contribution to international financial stability. His paper is also relevant for the countries in central and eastern Europe. The specific functions of the BIS are not developed further in this paper.

[65] Similarly, Crockett (1994).

[66] The Group of Ten, in considering the sequencing of the financial liberalization process, notes: "...whether a rapid comprehensive liberalization ("Big Bang") is better or worse than a more sequenced or gradual process depends critically upon the state of financial markets and their environment at the outset" (p. 48).

[67] The interdependencies between macro- and financial instability are documented, for example, in Goldstein and Turner (1996) and the Group of Ten (1997).

[68] Harwood (1997), in a summary of a Brookings Institute Conference on financial sequencing, concludes that there is no optimal path to financial sector development.

[69] On this point, see Pagano (1993), King and Levine (1993), Fry (1995) and Andersen and White (1996).

[70] There is quite a bit of literature emerging on the role of non-bank financial intermediaries. While this trend is to be observed carefully, especially in countries more advanced in the transition process, the role of these institutions is quite small as measured, for example, by the share in total financial assets.

[71] See Goldstein and Turner (1996), Lindgren et al. (1996), White (1997), Basle Committee on Banking Supervision (1997), Group of Ten (1997) and Folkerts-Landau and Lindgren (1998).

[72] Group of Ten (1997).

[73] Crockett (1996).

3.3 Growth and finance – the important link

(i) Introduction

The crucial link between growth and finance sets the framework for the ensuing discussion. While it is well documented that remedying financial instability is costly,[74] there is less evidence of a positive relationship between finance and growth. Most economists acknowledge the interaction between a solid financial system and the growth path. In general terms, a developed financial sector can raise the productivity of capital by improving its allocation. The elucidation of the empirical link between financial intermediation and economic growth has invariably been plagued by at least three major issues: the complexity of existing financial systems; the continuous changes taking place in the financial system as the borders between markets and agents become blurred and overlap; and changing "concepts" of growth.[75] However, some general conclusions have evolved from this empirical work[76] to influence our thinking on the state of the financial system. In the following section I have picked out four very important factors which have broadly been identified in these studies as being relevant for growth: excessive government involvement, low monetization, macroeconomic instability and unhealthy banks.[77]

While central bankers are essentially concerned about price stability, a second major goal of theirs may be "broadly called" financial stability. The four key variables identified above as being crucial for economic growth are assessed in fairly general terms in the following sections.

(ii) Selected factors in stimulating growth

(a) The crucial role of the government – too much?

The government will have to set the proper framework within which the financial system can prosper. The German concept of *Rahmenbedingungen* ("framework principles") captures the essence of what is required. The creation, life and death of a bank need to be properly institutionalized. In the area of banking supervision the Core Principles are the analogous concept. The "framework" for conducting banking business has to be ensured. Sound public finances are one of the cornerstones. There are many ways in which lax fiscal policy may undermine banking sector reform efforts, ranging from the overtaxation of banks through their preferential treatment in receiving government deposits (either interest rate free or free of reserve requirements) to their being obliged to hold government paper in their portfolios at below-market rates. Continuous "drip-feeding" of loss-making state enterprises by banks still represents a major problem in many countries (see section 3.3(ii)(d) below). While direct credits and directed credits are being phased out in general, governments may influence the allocation of credit to particular sectors, extend favourable loan-discounting privileges to certain borrowers, prevent private banks from engaging in certain profitable banking activities and direct banks to borrow in foreign currencies.[78] In a broader sense, confusing public and private interests strikes at the very nature of democracy, and reduces transparency and accountability.

It may also be important to limit government spending. The government sectors in many transition economies are still very large and may run sizeable deficits even in growth periods. Hungary's public sector, for example, accounts for 47 per cent of GDP. Large governments are more exposed to revenue shortfall in times of recession, and a large public debt leaves economies vulnerable to interest rate shocks. Government may also command the lion's share of credit, constraining the development of the private financial sector. Fragility in the public finances may thus have disastrous consequences for attempts at restructuring the banking system, either by blocking or retarding a smooth process of adjustment.

(b) Low monetization – but how to remedy it?

The central bank will have to be able to supply "final" liquidity to financial agents and is usually sought out to provide or act as agent for the payment and settlement system. In performing these major tasks the central bank should treat all participants and financial institutions equally.

The central bank is also often entrusted with the development of financial markets. This appears to be perfectly natural, and the process usually starts with foreign exchange markets, followed by government securities markets and then the interbank market. It is fairly consistently and rightly argued that fostering government debt markets is one of the financial priorities in emerging economies. The process, however, is fraught with pitfalls, takes time and requires constant monitoring. One of the main problems is to strike and maintain a delicate balance between government involvement and the evolution of the private markets. The awareness of the proper "exit" strategy for the government emerges as the individual financial markets develop resilience, depth and liquidity.

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[74] Lindgren et al. (1996).

[75] Koch (1997a).

[76] See, for example, World Bank (1989), King and Levine (1993) and Johnston and Pazarbasioglu (1995).

[77] Possible statistical proxies for these factors are, respectively, claims on the private sector/GDP; broad money/GDP; the real effective exchange rate and/or the real interest rate; and the lending minus the deposit rate.

[78] Goldstein and Turner (1996).

Monetary policy may provide wrong or biased signals during the process of banking sector reform. Russia, for example, singles out certain larger banks for closer supervision, thus presumably creating a circle of "better" banks which enjoy a "less risky" bonus. In Poland and Russia, state banks still appear to derive a privileged position from their extensive network of branches and state guarantees, a situation which reduces the efficiency of monetary policy. Such idiosyncrasies will have to be removed in the longer run. In a broader sense, monetary policy and government agencies have to ensure that the core functions of money are accepted by society. Low monetization (measured by the ratio of broad money to GDP) in almost all the transition economies in general reflects low levels of confidence in the traditional core money functions, namely, a store of value, an acceptable unit of account and a medium of exchange.[79] The development of reliable financial markets will overcome some of these transitory problems.

Dollarization still represents a major macro- and micro-constraint in those economies where confidence in the domestic currency is low. Open dollarization, i.e. the measurable component of dollars usually held in the form of deposits at commercial banks, may not capture the importance a foreign currency may play in the traditional functions of money. Dollarization presents a particular problem for the monetary authorities and may undermine the efficacy of policy. Moreover, a high level of dollarization may also jeopardize the development of the banking sector. Domestic residents holding large amounts of dollars "under the mattress" or conducting financial transactions among themselves without using money (barter, non-payment of bills) not only introduce inefficiencies into financial transactions but also weaken the growth of deposits at commercial banks (one component of national savings) and facilitate the avoidance of tax payments. Russia, for example, has taken firm measures in the past to boost the use of its domestic currency, the rouble, by prohibiting the use of foreign currency (in particular the dollar) in transactions. It appears that further dollarization of the economy has effectively been halted.[80]

Banking sector reform may be hampered if the underlying structural framework, in terms of the payment and settlement systems or an inconsistent or weak institutional policy, reinforces a low rate of monetization. The infrastructure found in more advanced economies is clearly extensive and will take time to develop. In addition to laws and regulations, it will include financial intermediaries such as banks, securities firms and insurance companies. Proper market transaction mechanisms are required for each market, ranging from such markets as repo and the other short-term money markets to capital markets and institutions such as stock exchanges, trading systems, clearing houses and registrars. Information sources such as credit systems may be desirable. Accounting systems are needed to provide standard, useful information on all market participants. While countries are at different stages in meeting these infrastructure requirements, and while it may not be possible or desirable to bring together all these ingredients in a preset framework, a sequence of steps has been evolving. In terms of institutions, this pattern may be characterized by the following stylized sequence: central bank, commercial banks and other non-bank financial intermediaries. In terms of markets, a frequently observed sequence has been: central bank liquidity facilities, foreign exchange market, interbank market, repo market, short-term government paper market, longer-term government paper markets, short-term private money markets and longer-term private markets.

(c) The macroeconomic framework

Serious macroeconomic distortions will, of course, also undermine banking sector reform. History has shown time and again that the macroeconomic parameters have to be under reasonable control for any reforms in the banking sector to yield tangible results. Recent works by many authors consistently conclude that an unstable macroeconomic environment is a principal source of vulnerability in the financial system. Significant swings in the performance of the real economy, and volatile real interest rates, exchange rates, asset prices and inflation rates make it difficult for banks to assess accurately the credit and market risks they might be incurring.[81] However, since macroeconomic stability is a necessary but not sufficient condition for ensuring financial stability, the implication is that more specific measures for ensuring financial stability are still warranted and are indeed urgently required.[82] A positive aspect in the current scenario is that in central and eastern Europe there is some convergence towards macroeconomic stability.

There are a couple of points to be made about macroeconomic policies. First, it is important to adopt policies that preserve monetary discipline. When faced with insolvent banks, many governments have in the past yielded to the temptation of relaxing monetary policy so much as to generate high inflation, negative real interest rates and devaluation. By eroding the real value of banks' bad loans, this tactic can appear to pay short-run dividends. But such policies typically provoke capital flight, shrinking the domestic deposit

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[79] For Slovenia, see, for example, OECD (1997a).

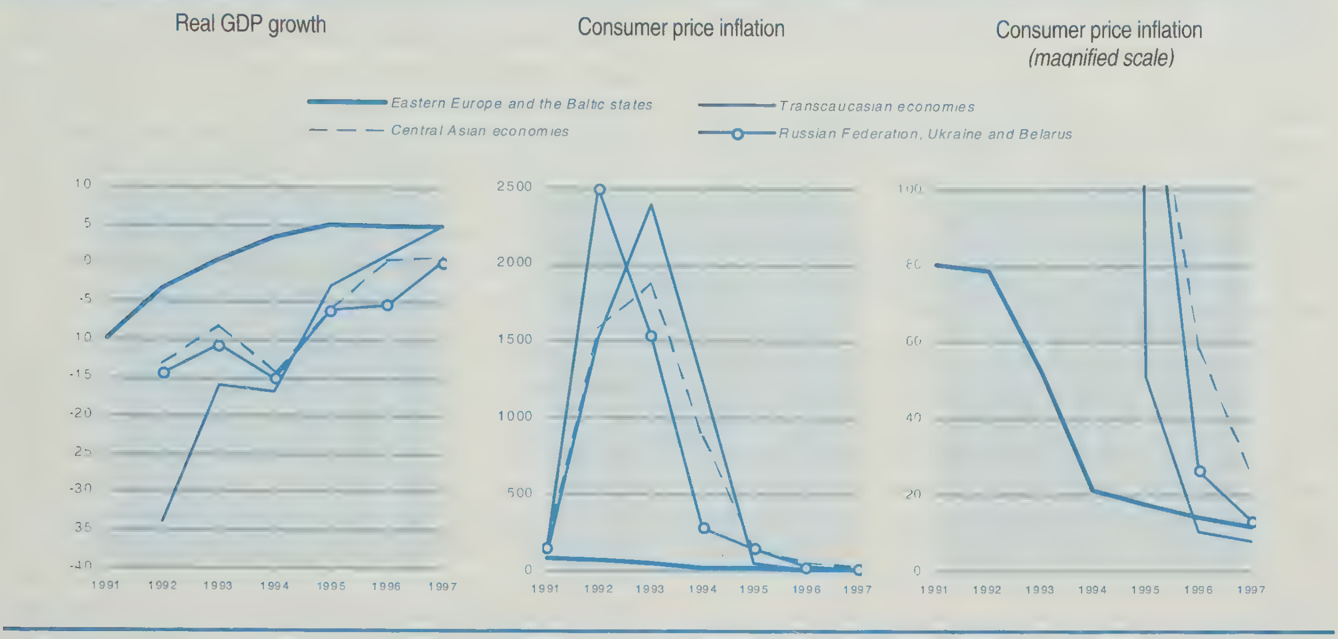
[80] Brodsky (1997). For a detailed account of barter and financing by non-payment, see OECD (1997b).

[81] Goldstein and Turner (1996) and Folkerts-Landau and Lindgren (1998).

[82] White (1998).

CHART 3.3.1

GDP growth and inflation in transition economies,[a] 1991-1997
(Percentages)



Source: National.

[a] Calculated using weights based on 1990 GDP and PPP exchange rates.

base of sound as well as unsound banks. Moreover, the memory of expropriation through inflation endures long after lax monetary policies have been reversed.

The second warning about macroeconomic policy is that governments need to be wary of allowing exchange rate misalignment to persist for too long. In many Latin American countries, tight monetary policies and/or fixed exchange rates led to significant reductions in inflation in the 1990s, but at the price of real exchange rate appreciation and widening current account deficits. Significant real effective appreciation until the first quarter of 1997 was also a factor in the economies most affected in the Asian financial crisis. Several east European countries may now face a similar dilemma. In Russia, the real effective exchange rate has risen by a factor of two during the last three years.

Current economic developments in many countries in central Europe may contain the seeds of a weakening of the banking sector. Rapid credit growth may indicate potential problems, since rapid real credit extension has been identified as a leading indicator of many banking crises. Across much of the central European region there has been a surge in real credit growth to the private sector, often matching increased consumer demand (see chart 3.3.2). In Estonia, vigorous economic growth has gone hand in hand with the growth of credit to the private sector in the order of 70 per cent annually. In Poland in 1997, the central bank twice raised banks' reserve requirements, nudged up the interest rate by about 2 per cent and started to take deposits from the general public in a bid to stem the credit boom. The latter has fuelled imports, which in turn have pushed trade and current accounts into deficit. The Czech koruna was forced to float and banking fragility was revealed in May 1997; again, the external scenario was a large and fast-growing current account deficit. Several other countries in the region are currently running high current account/GDP ratios.

An example of the distortions created by "weak" macroeconomic parameters is provided in Russia. The initial financial liberalization and loose entry requirements implied that the banks were able to speculate easily on the further depreciation of the rouble. They took advantage of this and earned large profits on their foreign exchange trade, while at the same time benefiting from high inflation rates. This profitable speculation came to an end with the introduction of the rouble corridor in June 1995. With the subsequent development of the government securities market, the banks again reaped easy profits as the nominal interest rates received on loans were much higher than the rates paid on deposits (i.e. the margins were very high). The upshot of these distorted macroeconomic parameters was that banking sector reform did not start in earnest. Owing to the existing macroeconomic environment, the incentive structure was distorted in favour of the banks, and the core elements of banking such as credit assessment and allocation and maturity transformation were not even established.

(d) Creating healthy banks

Privatization – what do we mean?

If the banking system is to contribute to growth rather than impede it, there must be a proper system of incentives to encourage productive lending and, even more importantly, to avoid lending that may lead to subsequent credit problems. This underlines the importance of credit analysis and the monitoring of banks together with appropriate supervision. However, when governments pre-empt a disproportionate share of private savings, the amount that is left to go though the financial system may be too small to stimulate effective financial intermediation and market development.[83]

If it is agreed that banks should be essentially private sector entities, then they should be run as private sector entities. Large government holdings of bank capital may indicate that banks are not in fact being run along commercial lines. Data on the privatization of banks in the central European economies, in terms of bank assets, loans, deposits and capital, demonstrate a willingness on the part of the state to privatize at least some of their state banks. Hungary has become the first country to declare explicitly that banks are no longer considered "strategic" assets and can be satisfactorily monitored without the state having an ownership stake.[84]

In Russia, the new law on the divestment of ownership in banks came into force in March of this year. According to this law, the central bank will maintain majority stakes in Sberbank, Vneshtorgbank, Moscow Narodny Bank, London, Eurobank, Paris and Ost-West Handelsbank, Frankfurt. The literature dealing with privatization on a theoretical basis as well as the results of practical experience does not, according to some economists, provide conclusive evidence as to the merits of the change in ownership from the state to the private sector.[85] Regardless of this discussion, it appears quite clear that the private side of banking needs further strengthening. This will remove any threat of government interference in what are essentially private sector decision-making processes; as foreign investors will almost inevitably wish to collaborate with the private sector and moves towards joining the EU will also advance this process. The EU accession process is likely to be a major driving force as a more competitive banking system will be a requirement of entry.[86] The recent parliamentary decision in the Slovak Republic to postpone privatization of the major state owned savings bank (as well as a dominant insurance company) until 2003 is likely to slow down adjustment in this sector.

While the timing and method of privatization are controversial issues, most would agree that demonopolization is a prerequisite for privatization: otherwise the new owners would simply be able to extract monopoly rents. Furthermore, the evidence from United Kingdom privatization programmes is that the major gains in labour productivity in state owned enterprises came from commercialization (i.e. enterprises being subjected to competitive pressure and run commercially) rather than privatization. Similarly, privatization when key prices are still controlled will mean that the new managers' decisions will be guided by a distorted set of relative prices and the opportunities for corruption enhanced.

Allowing "insiders" (managers or workers) to obtain control of state companies creates the risk that they will resist any change that worsens their own position. Moreover, methods of privatization that lead to a very dispersed ownership structure (e.g. voucher-based privatization) may in practice leave the old management with a free hand to resist adjustment. This is a particularly sore point if the providers of funds are overindulgent (as state banks have been) or if the state retains a controlling interest.

Effective privatization should thus go hand in hand with demonopolization and with banking business being conducted along commercial lines. The question of installing an adequately balanced incentive structure for managers, owners and employees remains crucial.

Continued bad loans and large margins between borrowing and lending

In their pursuit of operational efficiency banks face a host of serious problems: an asset portfolio that hinges on short termness, bad loans, little experience of credit standards, the existence of many new firms and undercapitalization. They may therefore appear to be more risk averse than their western counterparts. At the same time, large banking infrastructure investments are a necessity in today's world. The inheritance and the accumulation of new bad loans may have also made banks more cautious. They appear much more reluctant to assume their traditional role of maturity transformation. In particular, the lengthening of asset and credit portfolios may have to be addressed more seriously.

The aim has therefore invariably been to lengthen the maturity profile of the financial assets in the economy. This may be a long-term process; macroeconomic stability probably needs to have been established for some time before such longer-term markets can evolve, as illustrated by developments in Russia and the Czech Republic: by end-1997 only 2 per cent of total credits outstanding were for more than one year in Russia while the equivalent figure was nearly 30 per cent in the Czech Republic.

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[83] Crockett (1994); similarly, Kapoor (1997) and Keuschnigg (1997).

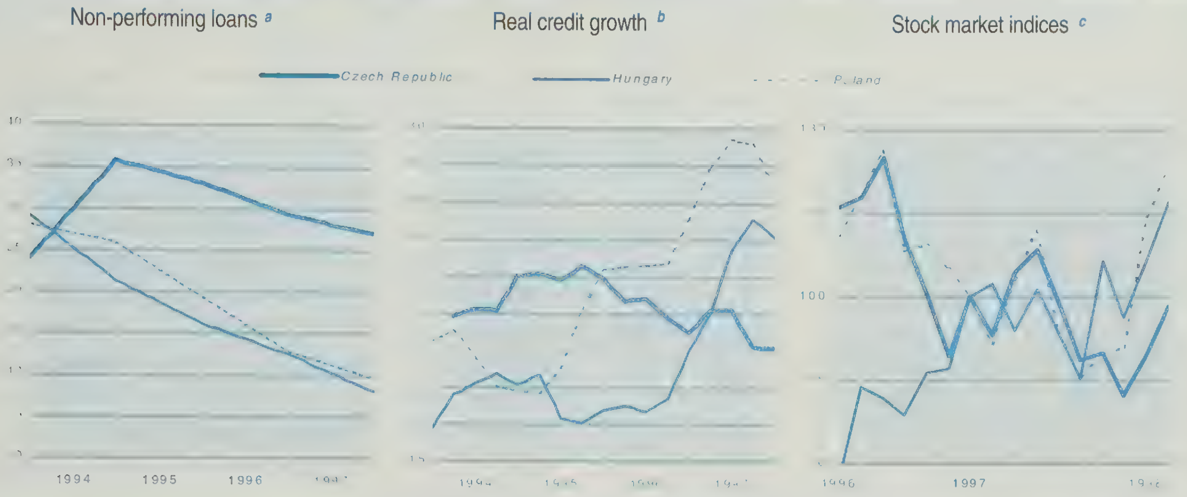
[84] See Borish et al. (1997) for the underlying data; for the privatization struggle in central European economies, see Kapoor (1997).

[85] OECD (1997c).

[86] Similarly, Keuschnigg (1997).

CHART 3.3.2

Financial indicators in eastern Europe, 1993-1998
(Percentages)


Non-performing loans [a]

Real credit growth [b]

Stock market indices [c]

Source: National.

[a] As a percentage of total loans.

[b] Four-quarter changes in credit to the private sector deflated by the annual rate of inflation (percentages).

[c] June 1997=100.

The inheritance of bad (or non-performing) loans[87] and the accumulation of "new" bad debts, to some extent perhaps unavoidable at the beginning of the transition, may have also led to more cautious behaviour by banks. Progress has been made in particular in Poland and Hungary as the average bad loan/total loan ratios have fallen from their peak levels of about three years ago (see chart 3.3.2). In these two countries, the bad loan constraint has largely been resolved. Dealing with the bad loan problem, however, still remains one of the most serious constraints on the performance of banks in the region. The literature on bad loans is already quite vast and individual country experiences in terms of solutions have been widely covered, especially the different approaches chosen by the Czech Republic, Hungary and Poland. While individual country approaches and the many problems encountered in implementing a given strategy have not been discussed, it has become clear that the process of containing bad loans will take a long time. When bad loans reach 70 per cent or 80 per cent of total loans held by individual banks, whose asset portfolios contain a large share of credits, as was the case with many Bulgarian banks before the crisis and some smaller Czech banks recently, urgent action is required. In the Czech Republic, the bad loan/total loan ratio has hardly changed.[88] The persistent "drip-feeding" of loss-making companies is tantamount to undermining the hard budget constraint on companies. This phenomenon is prevalent not only in the Czech Republic, but also in Croatia, Romania and the Slovak Republic.

It is not evident that government involvement in efforts to solve these problems has been successful. In Hungary, where state involvement has been heavy, the problem of moral hazard in bailing out banks has been quite prominent and there was hardly any real progress in clearing up bad loans in the initial phase of liberalization. It was the deliberate policy of letting foreign banks compete on the domestic market that was probably one of the main factors contributing to an improvement in the bad loan portfolio of the banking system. Banks with too much bad debt could not keep up with their competitors. Positive real economic developments may have helped to ease the bad loan problem in Poland, so that it may be difficult to attribute the fairly successful Polish experience to more "hands-off" government policies.

In spite of the success stories in some countries, in general bad loans still constitute one of the major problems of the region. To partly offset this drain on the asset side of banks' balance sheets, margins between borrowing and lending have remained high in comparison with banking systems in the traditional industrialized economies, even though they have narrowed in some countries. While in the industrial economies the margin is of the order of 2-3 per cent, it is twice as high in central Europe and even higher in some countries further east. The higher lending rates entail a cost to the economy, especially if they are high in real terms, thus potentially slowing down investments. At the same time, economic doctrine requires positive real deposit rates in order for savings to be created. The high margins thus give rise to a potential dilemma on both the asset and liability side of the banks' balance sheets. However, there may be some justification for these higher margins on account of the large investments required to boost the banks' financial infrastructure. Furthermore, higher interest rate margins may make the banking system as such profitable – an argument not easily dismissed. Generally interpreted as indicators of inefficiency in the banking system, large margins may nevertheless be justifiable at least for a limited period.

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[87] There is no international standard for the definition of a bad loan. In all cases, however, a loan is considered bad if it has not been serviced for a specified amount of time. Time elapsed may not be a good indicator of a loan's "quality". Definitions of time elapsed differ between countries. One major way to circumvent a loan being classified as "bad" is the capitalization of interest before the due date.

[88] The closing down of some smaller Czech banks with a very high proportion of bad loans on their books seems to explain the slight improvement during the last three years.

Bad loan categories should be reflected in loan-loss provisioning on the asset side of banks' balance sheets. In principle, provisioning should reflect the recoverable value of the underlying asset, the recoverable value being the actual market value. While reported provisioning levels have gone up in central Europe, there are doubts as to whether they are adequate. If a loan is collateralized, its recoverable value will be reduced if the collateral cannot be legally enforced. The experience in the Czech Republic, for example, seems to indicate that although collateral may appear sufficient, it does not de facto provide security to the lender if his claim is not enforceable.[89] Unfortunately, this situation may lead to a sense of false security on the part of the lender. Loan-loss provisions based on non-performing loans also do not take account of expected losses in loan portfolios. For example, the Swiss banks recently increased their loan-loss provisioning due to the Asian crisis. Banks' capital is frequently overstated, as charges are not taken for loans that have become non-performing.

Strengthening the capital base and credit assessment

Strengthening the capital base, like reducing bad debts, will increase confidence in the banking system. Banks are generally asked by their respective central banks (or supervisory authorities) to respect the BIS guidelines on capital adequacy. Whereas the 8 per cent capital adequacy ratio was out of reach for all countries at the beginning of transition, some countries now require ratios that are marginally higher than the Basle Committee recommendations. Estonia, following Latvia and Lithuania, raised the capital adequacy ratio from 8 per cent to 10 per cent in October 1997 (table 3.3.1). This higher requirement acknowledges that the banking systems in central and eastern Europe are still more fragile than in the western economies.[90] Banks operating in riskier environments need higher capital or liquid asset ratios. In crisis-hit Asia, capital adequacy ratios have only been significantly higher than prescribed by the BIS guidelines in Hong Kong (18 per cent) and Singapore (19 per cent), two countries that weathered the Asian storm relatively well.

Credit assessment and, in more general terms, the proper assessment of all balance sheet risks remain difficult issues. This applies in particular to the establishment and running of internal and external financial auditing procedures. However, the institutionalization of such risk assessment systems covering, *inter alia*, operational, credit and interest rate risk and the interlinkages between these various risks is a challenge for all commercial banks, not only for banks in eastern Europe.

Development of the markets and the tax environment

The development of individual money and capital markets should remain high on the transition agenda. It will not only accustom governments to borrowing at market rates but will also facilitate monetary policy implementation by allowing open market operations. This should foster the move away from direct monetary policy instruments to placing the interest rate mechanism at the centre of policy. Domestic borrowers may make use of these markets and foreigners may hold part of the related assets in their portfolios. Furthermore, longer-term markets provide a source of funding for domestic banks reducing the maturity transformation risk faced by all banks. Progress in establishing more complete markets is at different stages in individual countries.[91] Even in the more advanced economies of central Europe, there are few instruments with long maturities.

It may be necessary to take a fresh look at the fiscal treatment of banks. The tax environment does not appear dramatically different from that of some western economies, for example in terms of profit tax. However, tax evasion or the simple non-payment of tax is still much more widespread. High reserve requirements also place additional strains on the financial performance of banks.

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[89] Similarly, Kapoor (1997). This paragraph raises issues of transparency for the authorities as well as banking supervisory issues.

[90] This is not undisputed; see, for example, Keuschnigg (1997).

[91] An attempt at a cross-country view of the size of the foreign exchange market is made in Koch (1997b). For a discussion of the cautious approach to developing a foreign exchange market in Poland, see Malecki (1997).

TABLE 3.3.1

Banking supervision

	Bulgaria	*Czech Republic*	*Estonia*	*Hungary*	*Latvia*	*Lithuania*	*Poland*	*Romania*	*Slovak Republic*
Supervisory authority	Central bank	Central bank	Central bank	Supervision agency and central bank	Central bank	Central bank	Central bank	Central bank	Central bank
Establishing a bank:									
Types of licence	General/ limited	General/ limited	General	General/ special	Banking/ foreign exchange	Full/limited	Full/limited	Preliminary/ operational	Preliminary/ operational
Capital requirement[a]	BGL 450 million BGL 800 million	CZK 500 million	EEK 25 million	HUF 100 million HUF 500 million HUF 1 000 million	ECU 5 million (new banks)	LTL 10 million	ECU 5 million	ROL 12 billion	SKK 500 million
Capital requirement in dollars[b]	$6 million $11 million	$19 million	$2.2 million	$1 million $4 million $7 million	$6 million	$2.5 million	$6 million	$4.7 million	$17 million
Current business:									
Capital adequacy	8 per cent	8 per cent by end-1996	8 per cent	8 per cent by end-1994	10 per cent	13 per cent	8 per cent[c]	8 per cent	8 per cent by end-1996
Risk-weighted assets	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Large credit exposures[d]	25 per cent of capital	25 per cent of capital	25 per cent of own funds	25 per cent of capital	25 per cent of capital	30 per cent of capital	15 per cent of capital	20 per cent of own funds	40 per cent of capital[e]
Liquidity ratio	Not specified	Not specified	Not specified	10 per cent of weighted assets	Not specified	> 30 per cent of liabilities	Not specified	Minimum reserves	Not specified
Total open foreign exchange position	Limited	20 per cent of capital	No special limits	60 per cent of own funds	20 per cent as from beginning-1996	30 per cent of capital	30 per cent of capital	10 per cent of own funds	25 per cent of capital
Total non-bank participations	May not exceed equity capital	25 per cent of capital	–	60 per cent of capital	60 per cent of own funds	10 per cent of capital	25 per cent of capital	20 per cent of capital of non-banking entity	25 per cent of capital
Deposit insurance	Under consideration	≥ CZK 100 000	In preparation	≥ HUF 1 million	None	LTL 5 000	ECU 3 000	Under consideration	Under consideration
Reserves/provisions for bad debts	General: 1.25 per cent loans Provisions: unlimited	General: 1 per cent of loans Provisions for different risk categories	Yes	General: 1.25 per cent loans Provisions for different risk categories	Yes	Yes	Provisions for different risk categories	General: 2 per cent of loans	Provisions for different risk categories
Reporting requirements	Annual report	Annual report	Annual report	Annual report	Annual report	Annual report	Annual report	Annual report	Annual report
Audit	≥ 2 external auditors	External auditor	External auditor	External auditor	External auditor	≥ 1 external auditor	Chartered accountants	External audit not a legal obligation	International audit
On-site inspection	Possible	Possible	Yearly	Yearly	Yearly	Regular	Regular	Aim: yearly	Possible

Source: Bank for International Settlements, *Handbook on Central Banks of Central and Eastern Europe* (Basle, BIS, 1997).

[a] Multiple figures indicate different types of bank.

[b] At end-1995 exchange rates.

[c] New banks 15 per cent/12 per cent.

[d] Maximum per economic unit.

[e] 25 per cent as from end-1996.

Corporate governance – largely unresolved

The issue of corporate (including banking) governance is vast and complex. It has a bearing on the behaviour of individuals in relation to any incentive structure existing within their bank. Managers, owners and employees have to play their part in the delicate balance of power in corporate control. Mismanagement of funds, opportunities for fraud, asset-stripping and connected lending may be better contained if an adequate incentive structure is in place. The adequacy of such structures is a key element in bank restructuring. These issues are also the subjects of intense discussion in the industrial economies. Legal structure and actual control and/or behaviour may not coincide, rendering a legalistic/administrative approach useful but limited.

In summarizing the four crucial factors in promoting growth, discussed above, it is probably fair to assert that the government's role should not be squashing private initiatives. Higher monetization is probably also a key precondition for any sensible restructuring of banking. The interaction between the macro-environment and, in particular, the performance of the enterprise sector and the health of the banks hardly need stressing. Most transition economies have thus initially sought to provide a stable macro-framework. The paper also confirmed the general micro-financial weakness in many banks in the transition economies: a large share of non-performing loans, underdeveloped risk assessment and auditing systems in banks, and a weak capital base. However, here the intercountry differences in developments are particularly pronounced.[92]

3.4 Banking supervision – status and Core Principles – a must in avoiding crashes

A fragile domestic financial system may constrain the central banks in their pursuit of more stable policies. One factor, which needs to be addressed in the restructuring process, is banking supervision. In almost all the countries in transition, supervision is considered to be fairly weak. On the legal side, a large number of countries has already introduced adequate legislation, often leaning on EU legislation and BIS recommendations. For example, the legal framework created by the Czech Republic in 1995 is quite impressive. In Russia, the approach has been different, namely more pragmatic, as only selected larger banks are subject to close inspection. A summary of the status quo in June 1997 is shown in table 3.3.1.

Given that weak banking supervision has been identified as playing a major role in almost all banking crises, it needs to be seriously addressed. It is therefore advisable to implement the Core Principles of the Basle Committee on Banking Supervision without undue delay.[93] In practically all countries, the implementation of banking supervision will thus need to be accelerated. While a necessary condition of financial stability, banking supervision is neither a surrogate for nor a guarantee of such stability. Banking supervision will be most effective if it is seen as a corrective mechanism preventing systemic crises while preserving market discipline.

Transparency and prudent regulation in financial markets covers a wide range of issues from the timely release of reliable economic statistics to effective enforcement of conservative banking regulations, and capital market and company accounting rules that meet international standards. In the Asian crisis, the Republic of Korea turned out to have much more short-term debt than had previously been disclosed. Thailand for a long time withheld the true level of its foreign exchange reserves. In transition economies there are scores of conglomerates, companies and banks that do not reveal the true nature of their balance sheets. In some countries, such as Romania, archaic accounting rules are employed. Several of the region's stock markets remain poorly regulated. The "bad loans" also illustrate the problem. Invariably these were underrecorded in the initial phases of banking fragility. This has been well documented in central Europe, Japan and more recently in the Republic of Korea. All this leaves markets unable to price assets accurately and so deters investors. Reporting requirements in the economic and financial domain were increased in a wholesale fashion after the Mexican crisis in all the emerging economies. The quest for timely and more complete information on banks and the banking system is an ongoing process. As a result of the Asian crisis, the Hong Kong Monetary Authority (HKMA) has issued tighter guidelines to banks, requiring more detail on exposure to counterparties, the maturity profile of assets and liabilities, the sectoral composition of loan portfolios, and capital adequacy ratios with effect from end-1997. More recently the HKMA also raised the minimum capital requirements.

Next to these more short-term financial data it should not be overlooked that some basic structural data by economic agent and by instrument, for example, a flow of funds survey and corresponding balance sheets, is needed. These major gaps in current financial reporting in eastern Europe hamper the assessment of whether or not bank restructuring is moving in the right direction.

3.5 The supportive role of foreign banks

Foreign banks provide not only capital to weak banks, but also expertise in bank management and the technical know-how for creating a competitive environment. Perhaps their greatest advantage is that they can expose the unsound credit business of their domestic counterparts, notably connected lending and lending to loss-making enterprises.[94] Yet many policy makers continue to worry that few domestic banks are strong enough to withstand competition and possible foreign domination of the banking system remains an issue of acute political sensitivity.

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[92] See the caveats mentioned at the start of this paper.

[93] Basle Committee on Banking Supervision (1997).

The Hungarian authorities decided to allow foreign banks into the country before domestic banks had been fully restructured. Foreign banks, initially more profitable than domestic banks, have quickly integrated into the Hungarian domestic financial system. Non-residents, who owned 12½ per cent of the share capital of all banks in 1993, now own more than three quarters. In the Czech Republic, foreign banks now account for about one fourth of banking assets. Poland opted for a more gradual opening. Foreign banks were allowed to buy or merge only with certain domestic banks designated by the government, which sought foreign help in restructuring problem banks. The foreign response was not very enthusiastic because the banks on offer were mainly the weaker banks and because the lags involved in entry requirements (a two-year presence in the domestic market before foreign exchange business could be conducted) deterred potential entrants. At present, foreign banks hold only about 10 per cent of total banking assets. However, further liberalization is intended within the next two years as the country aims to join the European Union. Even so, competition in the banking sector already appears to be intense enough to pose a challenge to the dominance of the state banks. The Hungarian, and to a lesser extent the Polish, experience indicates that the financial sector should be open to qualified new entrants, including those from abroad. Various studies have shown that the fairly strong banking sector in these two economies owes a lot to the influx of these banks.

In Hungary and Poland foreign banks have initially been earning higher profits than domestic banks. As time elapses, however, and foreign banks become involved in retail banking, the difference in profit margins between foreign and domestic banks will tend to disappear and domestic banks should emerge strengthened from this process.[95]

Enhancing competition through further privatization, strengthening banking supervision, tightening disclosure standards and accelerating the entry of foreign banks (one aspect of reducing bad loans) are important milestones on the road to a sound financial system. The micro-fragility of many banks in terms of risk assessment systems and financial auditing remains high in many countries. What is more, low monetization, continued high dollarization, generally low savings and the high number of inefficient (loss-generating) enterprises render banking sector reform a hazardous task.

3.6 Non-bank financial intermediaries and conglomerates – high on the watch list

While it is true that non-bank financial enterprises in the majority of countries account for only between 2 and 5 per cent of total financial sector assets, they should also be carefully monitored from the beginning.[96] The restructuring of banks would not be complete without a look at the relationship between banks and other financial institutions. Financial restructuring should encompass banks and other financial institutions.

Two cases illustrate why the relationship between banks and other financial/industrial entities may have to be carefully monitored. The connections between banks, investment funds and enterprises in the Czech Republic were a major factor in the financial crisis in 1997. Evolving FIGs (Financial Industrial Groups) in Russia have been identified as one of the major concerns, particularly abroad. The main problem is that the newly emerging FIGs may threaten the transition to a more market-driven economy. It is estimated that six to eight FIGs account for up to half of Russia's hard currency earnings. FIGs are usually centred on a bank and their vast holdings normally include raw material enterprises and media outlets. The main immediate worry is that they are not operating on a "level playing field", but enjoy state privileges such as "free" government deposits and special tax breaks. The principle of "fair competition" is thus at risk. Adequate corporate governance, openness, competition and banking supervision may all be more easily compromised in the presence of such a financial structure.[97]

3.7 Conclusion

In the final analysis, there is no ideal way of conducting a reform of the banking sector. While some "Big Bang" reforms have been successful, as in the United Kingdom in the late 1980s, in many countries serious thought was given to financial restructuring only under duress. Since the banking crises in individual countries tend to be resolved at a high cost, there seems to be general agreement that preventive action is essential. That cautious approach would place a premium on the stability and safety of the evolving financial system.

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[94] Goldstein and Turner (1996).

[95] For Hungary, see Karvalits (1997); for Poland, see Mondschean and Opiela (1997).

[96] One important aspect is the evolution of pension funds (see Vittas and Michelitsch (1995)). The public/private sector split and the move from a pay-as-you-go system to a funded system are major points of discussion.

[97] For more details on these concerns, see OECD (1997b).

Some of the core elements in this process are sound government institutions, effective legal mechanisms, broad financial supervision, and the requirement that each individual market have a sound infrastructure. The Group of Ten's Working Party on Financial Stability in Emerging Market Economies (1997) recently developed a broad framework, the major elements of which are listed in the annex to this paper.[98] In fact, international financial institutions have used up substantial, sometimes pooled, resources in moving towards such a framework of financial stability. Questions of interdependency, sequencing and the resulting complexities are also important. One widely accepted conclusion is that to liberalize financial markets, and especially the capital account in the balance of payments, is not sensible if the supervisory and regulatory framework is inadequate or weak.

A country's particular circumstances – its macroeconomic, financial, legal and political systems and particularly the government's behaviour towards the market – will influence the steps it should take in creating a sounder banking system.[99] This paper has elaborated on only a few of the critical elements of this broader framework. Three of the current barriers on the path to successful bank restructuring are worth repeating here: government involvement which throttles financial developments in the private sector; low monetization, which prevents serious intermediation efforts by banks; and the fact that most banks in the region remain weak and need strengthening.

There are several areas in which more immediate determined action is possible. The bad loan problem needs further attention, as it is one of the major constraints on banking reform. The role played by foreign capital in the development of the banking sector requires reassessment in several countries. Financial supervision and its implementation need to be further strengthened in nearly all countries along the lines of the Core Principles for banking supervision. The gaps in financial reporting should also be addressed immediately.

A clearer path towards a stable financial sector has been laid during the last few years by the international financial institutions. The responsibility for reaching the destination, however, is placed squarely with the national authorities and needs constant attention in each individual country.

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[98] While each country can take stock of its financial system on the basis of the framework, reference should be made to the caveats in sect. 3.2.

[99] Similarly, Harwood (1997).

Annex to chapter 3

ILLUSTRATIVE LIST OF INDICATORS OF ROBUST FINANCIAL SYSTEMS

(i) Legal and juridical framework

- Well-defined property rights and contract law
- Market contracts easily enforceable in practice
- Ability to pledge and seize collateral
- Well-developed bankruptcy code

(ii) Accounting, disclosure and transparency

- Loan valuation, asset classification and provisioning practices reflecting sound assessment of counterparties
- Effective and regular auditing mechanisms
- Information on the creditworthiness of financial institutions made publicly available on a regular, frequent basis
- Timely publication of relevant aggregate financial data (macroeconomic indicators, reserves, banking sector statistics, etc.)
- Availability of impartial credit-rating or credit information facilities

(iii) Stakeholder oversight and institutional governance

- Capital adequacy requirements commensurate with risk
- Replacement of management for poor performance
- Enforceable legal liability of managers
- Pervasive use of effective systems of risk management and internal control

(iv) Market structure

- Financial sector open to qualified new entrants, including those from abroad
- Share of foreign participants in total assets
- Financial sector concentration ratios
- Liquid interbank money and capital markets
- Regulations permitting a full range of financial instruments
- Sound and effective payment and settlement systems
- Share of banking system assets held by public sector financial institutions

(v) Supervisory/regulatory authority

- Independent from political interference in the daily conduct of supervision and appropriate accountability for achieving clearly defined objectives
- Power to force disclosure, impose penalties, etc.
- Adequate resources for staffing, training, compensation
- Conducts supervision on a consolidated basis
- Shares information with other supervisors
- Verification of information on risk management and internal control systems and on asset quality by regular examinations or external audits
- Adherence to norms established by international consultative bodies (Basle Committee, etc.):
  - In principle
  - In practice
- Measures to address particular types of risk:
  - Evaluation of risk management systems
  - Connected lending
  - Risk exposure and loan concentration
  - Special attention to foreign currency and interest rate risk management and exposures
  - Heightened scrutiny of asset quality and capital adequacy in the face of sharp asset price movements
- Strategy for addressing financial insolvency:
  - Procedures for prompt corrective action or the equivalent
  - Appropriate exit policy

(vi) Design of the safety net

- Explicit rather than implicit deposit insurance, paid for by banks and targeted especially towards protecting small depositors
- Appropriate allocation of losses among stakeholders
- Stringent conditionality for the use of public money

Source: Group of Ten (1997), annex 1.

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Discussion of chapter 3

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Dr. Koch has provided a very good summary and overview of central banking issues in transition economies and I agree with most of his conclusions. Here I would like to comment on a few points and use certain aspects of his paper as a stepping stone to discuss the more general issue of the fragility of banking systems in transition economies. The theme of the paper is straightforward: a stable financial system enhances growth, the banking system is an integral part of the financial system (in which the BIS has a primary interest); there are still systemic weaknesses and incipient bank crises with which we should be concerned; but, of course, it is the ultimate responsibility of the national authorities to address these concerns. I should emphasize though, that while it is the responsibility of national authorities to address these concerns there are both positive and negative spillovers to major trading and investing partners of these countries. Hence, the interest of those attending this meeting.

This paper serves as a foundation for the analysis of the question of whether the banking systems of these economies are vulnerable to external shocks similar to those experienced by countries in South-East Asia? First, one may ask why is this important? Simple: there have been 120 financial and banking crises between 1970 and 1996. Since 1980 there have been more than a dozen banking crises in developing countries which cost more than 10 per cent of GDP. The Mexican currency crisis cost 6 per cent of GDP in 1995 alone.[100] There are significant real economic costs which negatively impact growth and the standard of living as a result of these crises. If this were to happen to a relatively open transition economy the spillover to other ECE member states could be significant.

Dr. Koch offers several caveats, two of which are worth repeating and emphasizing more than the others. First, the financial system is more than the banking system. Non-bank financial institutions are developing within an immature legal and sociopolitical system as well. Money and capital markets and the insurance industry are all evolving and financially linked to the banking system. Instability in one of these areas could readily contribute to instability in the banking system. Second, the economies in transition are not homogeneous and an analysis of the entire region as a group is not very useful. Koch's disclaimer is well taken.

Now, on what should central bankers concentrate? Their primary concern is reducing or eliminating "contagion risk" or systemic risk and not so much the status of an individual bank. In Poland, Hungary and the Czech Republic the banking systems have been recapitalized and the banking industry is undergoing consolidation as weaker banks are restructured, merged or sold. So far regulatory authorities have handled these tasks reasonably well: not without huge costs, but without a systemic crisis, and there have been no unmanageable external shocks.

There remains a significant problem, however, because in transition economies the underdevelopment of the non-bank financial institutions coupled with international capital movements may easily overwhelm a fragile banking system. It is unlikely that an old-fashioned run on a bank (or banks) will cause a crisis in the financial system. Stocks and bonds are the primary vehicle for foreign investment rather than bank lending (domestic or foreign) to enterprises or governments. Thus, it is more likely that the interaction of non-bank financial institutions and international capital and money movements will be the source of a financial crisis. This is not only because of the large magnitude of foreign investment through these channels, but also because they are relatively less well developed than the banking system. Because systemic crises result from shocks which interfere with information flows and the efficient allocation of financial resources, we must examine the channels of information closely. Information flows within the banking system have improved and continue to improve, but among banks, financial market institutions, market participants and government authorities at the ministry and central bank level as well as regulatory and supervisory authorities, information flows slowly, indirectly and is not uniformly accessible by all interested parties. Adverse selection, moral hazard and free rider problems arise precisely from the asymmetric information we see in transition economies.

Banking regulations and supervisory agencies are designed specifically to solve these problems and significant progress has been made in this area in the central European economies. This is not to minimize the potential of banking system problems because the regulatory and supervisory systems in many of the countries are still underdeveloped by market economy standards and, in many ways, untested. In certain other transition economies these mechanisms are almost completely lacking and thus they are even more vulnerable to shocks which distort or limit the flow of information.

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[100] See M. Goldstein, "The causes and propagation of financial instability: lessons for policy makers", *Maintaining Financial Stability in a Global Economy*, a symposium sponsored by The Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 28-30 August 1997.

Are the authorities ready for an event such as the crisis in South-East Asia? To avoid such a problem we must have in place a system which continuously monitors foreign currency denominated assets and liabilities of the government, the banking/financial system and the maturity and liquidity of both assets and liabilities.[101] Because the foreign exchange market links domestic currency assets and liabilities with foreign currency assets and liabilities it is particularly important to have an exchange rate system which is informationally efficient and flexible enough to absorb external shocks. The system must not eliminate exchange risk, as a fixed exchange rate system may be thought to do under ideal coordinated macroeconomic policies, but it must effectively price the risk. The critical policy error in the crises in both Mexico and Thailand is that the authorities held to a fixed exchange rate too long and policy credibility was eroded. Real exchange rate misalignments, pointedly revealed by rapidly declining international reserves, were corrected by currency devaluations which shocked the banking systems, causing the domestic economic crises. In transition economies the "dollarization" of the domestic economies is probably greater, but the amount of short-term dollar denominated debt is much less. A careful analysis of the balance sheets of banks to ensure coverage of exchange rate risk is critical. This is one very important role of bank supervision and regulation.

Dr. Koch emphasizes the link between the financial system and growth. One of the major concerns of central bankers is price stability, and rightly so. In addition to issues of intergenerational wealth transfer, inflation hinders the efficient allocation of capital and conceals and weakens the signals of relative price changes; in effect, continuing the subsidization of inefficient producers and taxing efficient producers. Inflation in a transition economy is particularly problematic because it hinders transition and restructuring within the productive sphere.

Also, central bankers must be concerned with the institutional, supervisory and solvency aspects of the banking system. Koch identifies four major problems: low monetization, macro-stability, excessive government involvement and generally unhealthy banks. While low monetization is primarily a function of the confidence of individuals in the system, the other three problems are closely interlinked. Macro-stability is the foundation for creating a healthy banking system and requires appropriate monetary and fiscal policies. Macroeconomic policies should limit price distortions and promote growth by limiting the volatility of critical economic parameters such as the general price level, exchange rates and interest rates. When these parameters are volatile individual agents, both private and public, cannot evaluate risk, the development of long-term capital markets is hindered and poor lending decisions are made, which in the aggregate may be a threat to the system. To the extent that restructuring and recapitalization takes place within a stable macroeconomic environment, the chances of success are greater and the cost of restructuring is less. Much of the success of Poland in this area may be attributed to the growth of the economy as a whole. Marginal enterprises which received loans are more likely to be profitable in an environment of growth. Thus, monetary policy emphasizing price stability and reasonable, growth oriented (non-inflationary) fiscal policies should be emphasized first and foremost so that the likelihood of successful restructuring will be greater. Creating sound banks requires more than sound macro-policy, however.

There are essentially two stumbling blocks which have hindered the restructuring and effective recapitalization of the banking systems. In reality central banking authorities have been caught between excessive expansion of government budget financing needs and poor lending on the part of commercial banks. On the one hand, in many transition economies central bankers must pursue a monetary policy objective of price stability in an excessively expansionary fiscal environment. Because of the underdeveloped money markets open market operations are of limited use. Monetary authorities are therefore left with increasing discount rates and reserve requirements which tax the banking system. On the other hand, relatively inexperienced commercial bankers have pursued lending policies which have jeopardized the solvency of the banking system. The continued lending to enterprises whose long-term survival is doubtful is a result of the inability to price risk and of high interest rates dictated by the monetary policy. The latter has led to the expected adverse selection problems which aggravate the bad loan problem: only enterprises willing to take high risk or having an implicit guarantee from the state are also willing to pay the high interest rates. Thus, central bankers are walking a very fine line. Monetary policy is being implemented with only two of the traditional monetary instruments, in an institutional setting where the creditworthiness of potential clients is difficult to ascertain and where the institutional mechanisms to monitor bank lending are weak. This is quite a challenging task.

The necessary institutional changes are taking place in the transition economies at varying rates. The requirements for a successful restructuring of the banking system are: demonopolization and privatization; legal, enforceable contractual relationships regarding collateral; strengthening the bank capital base (to meet BIS standards); better corporate governance; and improving techniques for credit and risk assessment (without which nothing else matters). While each of these is a substantial task central bankers must focus on banking supervision with the understanding that it is necessary but not sufficient. Through careful, consistent supervisory activities the central bank (or regulatory authorities) can lessen the "bad loan" problem. This requires better accounting systems and the consistent application of banking standards to ensure transparency and to reduce asymmetric information.

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[101] There is a host of "early warning indicators" for financial crises in developing countries. See M. Goldstein and C. Reinhart, *Forecasting Financial Crises: Early Warning Signals for Emerging Markets* (Washington, D.C., Institute for International Economics, 1997).

Central banking authorities have made tremendous progress, but a decade-long agenda still remains. The banking systems can be stabilized and will contribute to transition in other sectors of the economy in the near term in most of the transition economies. Let me conclude with a warning, however. As mentioned at the outset, we need to be aware of the interconnectedness of the banking system with other parts of the non-bank financial system (investment funds, the stock market and foreign exchange markets, in particular), since activities in the non-bank financial system may be the source of systemic instability. Government intervention or regulation of financial markets, new instruments or other innovative activity typically occur after the fact. The government intervenes to protect the public interest usually as a result of "entrepreneurial" activities within an environment of imperfect information. And, information is very imperfect in the transition economies. This is the dilemma individual agents, government authorities and central bankers will continue to face for some time to come.

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In my comments,[102] I would like to concentrate on the future development of banking systems in the central and east European countries (CEECs). In doing so, I shall first deal with the factors that, in my view, are driving the development of financial intermediation in the region: economic transformation, financial liberalization, catching up and future EU membership. As we shall see later, the relative importance of these factors is changing over time and differs between countries according to the different phases of their economic transformation. I shall then discuss the role and nature of foreign participation in the banking systems of the CEECs. For several reasons, foreign participation will be much more important in CEECs than in any other developing countries at similar levels of development. Finally, I would like to concentrate on the new challenges the banking systems of the CEECs will – and in the lead countries already do – face. In doing so, I shall mostly draw upon the Hungarian experience.

Factors driving the development of financial intermediation in CEECs

Economic transformation

The process of economic transformation is characterized by rapid and massive changes in relative prices, including asset prices and interest rates, due to the liberalization of trade, reorientation of foreign trade, changing product structures and production technologies. These changes result in the deterioration of the net present value (NPV) of a large proportion of existing loan contracts (underlying investment projects) – many of which had negative NPV from the very moment of their origin – leading to pervasive bad loan problems. Economic transformation is also associated with institutional and legal reforms, including the creation of two-tier banking systems, legislation on bankruptcy and prudential regulations. These changes make the bad loan problem much more transparent and increase the pressure on financial authorities to deal with the issue.

Financial liberalization

CEECs liberalized their financial systems early on in the transition process and at a much earlier stage in their development process than the present developed market economies. Moreover, it was carried out in a very short period giving much less time and "breathing space" to financial institutions, mainly banks, to adjust to it. The essence of financial liberalization – as with any other form of liberalization – is to let the market determine the relative prices of financial products and services and allocate financial resources across potential borrowers. Moreover, as financial services are generally licensed, liberalization also means less restrictive licensing leading to increased competition. The consequence of the process for financial institutions is that they have to reallocate their own resources according to the changing relative prices, otherwise their profitability may rapidly deteriorate. There may be a temporary deterioration of profitability even if they do adjust, as adjustment is an inherently slower process than changes in relative prices and market structures. For banks, this means potentially the narrowing of spreads on traditional products and the loss of part of their deposit base and corporate lending business, although the latter is a much slower process and is taking place only in the lead countries.

Catching up

CEECs will be the first countries to embark upon a catching up process in a highly liberalized environment. In the associated countries, due to their Europe Agreements, trade by now is almost fully liberalized, and in the countries that were invited to join the EU in the first wave, all the remaining restrictions on the free movement of goods and services, including financial services, will be phased out in the coming four to five years. Entry into the financial services industry is being gradually liberalized, and this process will have to be fully completed within the same time period. Foreign financial firms will also be free to provide financial services across borders. As a result:

- Allocative efficiency will be enforced upon these countries at a much lower income level than in previous catching up experiences and thus make these economies more robust in the longer run, but most likely more volatile in the short run;

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[102] The views expressed here are those of the author and do not necessarily represent the views of any of the institutions with which the author is affiliated.

- Foreign participation and the importance of foreign investment will be greater than in previous successful catching up economies. Capital inflow, especially in those countries that manage to create a stable macroeconomic environment and have a realistic chance of joining the EU, could become very large;
- Foreign exchange risk will be sizeable within the system, a large proportion of which will have to be partly assumed and managed by the banking system;
- It will be difficult to maintain a level of domestic real interest rates that is substantially higher than in developed market economies (in the euro zone).

Future EU membership

Preparation for future EU membership will drive the institutional and legal reforms. The legal and institutional systems of the Union will be adopted at a much lower income level than in any previous enlargement.

The relative importance of these factors is changing over time. In the early phase, the development of the banking sector is mostly determined by the transition process. The dominant issues are thus the bad loans problem and the privatization of state owned commercial banks (SOCBs), or more broadly the corporate governance problem in SOCBs. As the countries progress with transition and the privatization and deregulation of the economy reaches a certain level, financial liberalization and catching up will gradually become the dominant factors. In the lead countries, the importance of these factors is further increased first by the association agreements with the EU (Europe Agreements) and later by the process of membership preparations. As membership becomes a reality, the dynamics and the nature of the process change, and the impact of the transition will rapidly fade away. From there on, the problems these banking systems face will be very similar to those that the banking systems of more developed countries currently face, or have faced during the second half of the 1980s. The difference, however, is that the speed with which this transition towards a world of fully integrated and, to a large extent, liberalized financial markets is taking place is much greater than was – or is – the case in the developed market economies. This of course increases the vulnerability of these financial systems and the importance of prudential regulations and supervision.

Foreign participation

The CEECs started their economic transformation with a very underdeveloped financial system which was hardly more than a banking system with banks that had been carved out of the monobank system either at the outset of transition or just a few years prior to that. This meant, on the one hand, that banking markets were highly concentrated and inefficient and, on the other hand, that a more liberal licensing of domestic *de novo* banks was almost inevitable. Both factors contributed to the emergence of imprudent banking practices due to the lack of expertise and inadequate prudential regulation and weak supervision. That naturally led, although at different speeds and to varying extents in different countries, to the conclusion that foreign participation in banking is a necessary characteristic of banking in the region.

What is important to emphasize about foreign participation, in particular foreign ownership of financial institutions, is not that it is foreign, but that it can help these countries to solve some of the major problems their financial systems, in particular banking, face, provided that they find the right foreign partners. Foreign participation, especially foreign ownership, does not in itself solve any problem. What foreign participation can bring is expertise, which is precisely what these countries most lack, especially at the beginning of the transition process. But this assumes a strategic partner (investor). Moreover, a foreign strategic owner with reputational capital has much stronger incentives to conduct sound business, as what it has at stake is not only the capital it invests but also its reputation. Damage to the latter may be extremely costly. Foreign owners can also contribute to strengthening the capital base of financial institutions, especially banks. Adequate capital strength is a prerequisite for a sound and safe financial (banking) system. At the beginning of transition the banking systems of the CEECs were typically undercapitalized, therefore it was critical, and in some cases it still is, to strengthen the capital base of the banks. Foreign banks, especially newly established and fully foreign owned ones, have typically high capital adequacy ratios, well above the level required by prudential regulations.

It is also important to point out what these countries cannot expect from foreign investors. The general experience of those countries that have successfully privatized SOCBs is that foreign investors are not willing to take over a bank before its portfolio has been cleaned up, or in the rare cases where they do, they insist on the option of being able to transfer assets of the purchased bank back to the government at book value if they find this is higher than their real value. That is, the cleaning up of existing portfolios should proceed privatization.

New challenges [103]

The impact of financial disintermediation on banks

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[103] In discussing the new challenges that banks face in the lead CEECs, I draw upon the recent experience of the Hungarian banks. Concerning the banking system, and due to the substantial foreign participation and the liberalization of the financial system, Hungary in this respect is perhaps somewhat ahead of the other leading reform countries. Thus, its development may be a good indicator of future trends in the other countries of the region.

At the beginning of economic transformation, financial intermediation was hardly more than intermediation by banks. Since then, however, at least in the countries most advanced with financial liberalization, financial disintermediation has speeded up. It has an impact on both the asset and liability sides of the balance sheet of banks, as well as on the structure of their revenues and on their profitability. It is true that, even in the lead countries, the overwhelming proportion of financial wealth of households, corporate units and foreign investors is in the form of financial products that are either on the books of banks, or the issuance of which was organized by banks. However, if we look at the *increment*, in Hungary the share of non-traditional banking products is about one half. This trend will be further strengthened by the newly introduced pension reform. On the other hand, banks are reacting to this trend by entering the markets for non-traditional financial products, by acquiring investment banks and brokerage firms, that is, by moving towards universal banking. The increased competition in the markets for traditional banking products has resulted in a sizeable reduction in the spreads on these products and thus in a reduction of the share of net interest revenue in the total revenues of banks. This puts pressure on the banks to improve their services, increase productivity, improve the quality of credit assessment, cease cross-subsidizing and preferential lending, unless they are supported by direct government subsidies, and enter riskier markets.

Off-balance-sheet activities

The increase in the off-balance-sheet activities of Hungarian banks was around 80 per cent in 1997 and the ratio between off- and on-balance-sheet activities increased from 27 to 40 per cent. This rapid growth is mainly driven by the increase in derivatives used to cover open foreign exchange positions, but the importance of derivatives used to cover interest rate risk is also increasing. While this rapid increase in off-balance-sheet activities is mainly due to the increased need of banks to cover their open positions created by prudential regulations, off-balance-sheet items may expose banks to new types of risk. Unless prudential regulations keep pace with the rapid development of these markets, this trend may create a new source of systemic risk.

Rapid increase in corporate lending

As a result of institutional and legal reforms and improved macroeconomic management, the lead countries have all experienced a rapid increase in corporate lending. During the upturn corporate units have enjoyed strong cash flows, and thus the quality of this new loan portfolio appears to be good. This, and the increased competition on this market, drives spreads down to a degree that may result in an underpricing of risk. The real test of the quality of this new loan portfolio will come when the first recession hits these economies. Moreover, the increase is mainly in term lending while the increase in term deposits and other longer-term sources of loanable funds is much more moderate. That is, the maturity mismatch in the books of banks is also increasing. The typical source of longer-term money is foreign borrowing. In this case, although the maturity mismatch may not be a problem, the increased foreign exchange risk is.

New state owned special purpose banks

As I pointed out earlier when I discussed the impact of economic transformation and financial liberalization on banks in the CEECs, privatized commercial banks have gradually abandoned lending schemes that were intended to support the development programmes and priorities of government, or which were vehicles for subsidizing selected corporate units. This development has naturally led to the need to create special purpose banks to assume these functions, such as State Development Banks or Eximbanks. While these banks may well serve important functions of government, it is essential that proper corporate governance and prudent business practices are imposed upon them early on in their lives. It is also important that subsidies through these banks are made explicit in order for the market to be able to assess properly the fiscal stance and contingent liabilities of the government in these countries.

CHAPTER 4

ENTERPRISE AND BANK RESTRUCTURING IN RUSSIA[104]

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4.1 Introduction

It is widely accepted in the literature that microeconomic reforms are unlikely to be successful in an environment of high inflation and macroeconomic instability. There is an alternative point of view, however, which argues that macroeconomic stabilization has been held back in Russia because there has been little change at the enterprise level, most firms behaving as they did in Soviet times. It is not the intention of this paper to argue for or against these viewpoints. Neither does it pretend to cover all aspects of enterprise and bank restructuring in Russia, as a number of interesting studies have been recently released by various authors (Alfandi and Schaffer (1996), OECD (1997), Earle and Estrin (1997), Schaffer (1997)). Instead, the paper attempts to analyse some of those problems that might be linked to the country's macroeconomic performance. Thus, some of the relevant macroeconomic issues are also discussed.

From the onset of transition Russia experienced a deep fall in production. According to official statistics released by the Central Committee on Statistics (Goskomstat), Russian GDP in 1996 was some 58.9 per cent of its 1990 level. The output decline in industry was even deeper (47.7 per cent of 1990 industrial output). Investment contracted by 75 per cent during the same period. For several years the country suffered from high inflation and huge public sector deficits. The macroeconomic environment was also unsatisfactory due to unsettled "rules of the game" and a weak legal system. The first visible signs of macroeconomic recovery appeared in 1997 when, according to official statistics, the country's GDP grew by 0.4 per cent and industrial output increased by 1.9 per cent compared with the preceding year. This occurred against a background of relatively low inflation (consumer prices in 1997 increased by 11 per cent, producer prices in industry grew by 7.4 per cent).

Russian statistics usually generate a number of puzzles. One of the earlier papers related to this problem, published by Gavrilenkov and Koen (1994), attempted to reappraise official Goskomstat GDP figures. The paper argued that GDP was likely to have contracted by one third instead of one half as was reported by Goskomstat at that time. A year later Goskomstat officially revised the historical GDP statistics, accepting, in fact, the estimates of Gavrilenkov and Koen. One outcome of those revisions was that a picture of firms' behaviour emerged which seemed to be quite different from that previously presented by the official statistics. Firms appeared to be more flexible and able to adjust to the new environment.

Statistical inconsistencies can again be seen in the 1997-1998 figures, and visible macro-level statistical distortions may reflect some new developments at the enterprise level. Thus, in order to reconcile a number of inconsistencies, Goskomstat has increased, since 1997, the share of the shadow economy in GDP. Although this has helped to present a smooth picture for 1997, it has created new problems for 1998. In fact, in the regular Goskomstat publications released in February and March, nominal GDP in January 1998 was reported as R202 billion (in re-denominated roubles), while it was equal to R202 billion in January 1997 (also in new roubles).[105] This did not correspond at all to price increases in January 1998 measured over January 1997 (10.1 per cent for CPI and 7.1 per cent for PPI) or the real growth rate. A similar inconsistency can also be seen in the data for February 1998. Later, Goskomstat downgraded the January-February 1998 figures substantially (by 7 per cent) while leaving the 1997 statistics unchanged. This did not solve the puzzle, which was revealed at the quarterly level, and in May the Goskomstat revised the 1996-1997 GDP figures. Due to the instability of historical data one can say that the actual rate of output growth is hidden among several inconsistencies and it is difficult to make a distinction between, say, ± 1.5 per cent, while real enterprise performance also looks quite puzzling in such an environment. Some of these issues will be discussed below.

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[104] The views expressed in the paper are those of the author who is responsible for any judgements formulated, as well as for any errors.

[105] Under the previous rouble denomination, GDP in January 1997 was R202 trillion.

Despite the above-mentioned statistical mysteries there is no doubt that in 1997 the Russian economy delivered its best performance so far in the 1990s. Investment activity, which started picking up in autumn 1997, indicates that the macroeconomic environment had begun to improve. Although total investment dropped by 5 per cent in 1997, production investment contracted by only 1.1 per cent. More importantly, in the second half of the year production investment began growing (it increased 2.8 and 2.2 per cent, respectively, in the third and fourth quarters relative to the same periods of 1996). Investment mostly came from domestic sources of which about 62 per cent came from firms' profits and depreciation funds (52 per cent in 1996), and 19 per cent from federal and local budgets. The rest was financed through borrowing, some coming from individuals, foreign capital and extra-budgetary investment funds. The share of investment financed by bank credits (2.6 per cent of total investment), was as low as in 1996. In fact, while inflation was falling in 1996-1997, lending rates were also decreasing, but they were still relatively high (in October-November 1997 they fluctuated around 32-33 per cent). These figures show that the role of banks as creditors of fixed investment had still not changed much: they were largely lending to the government (the nominal stock of government securities in circulation increased in 1997 by 57 per cent, which meant that in real terms it grew by nearly 43 per cent). At the same time, the rise in firms' investment activity indicated some behavioural changes in the real sector, with investors gaining more confidence.

Nevertheless, it should once again be emphasized that caution is required in interpreting Russian macroeconomic statistics. This does not only apply to the reliability of data, but also to qualitative structural changes that can be easily observed in the economy. In fact, some figures, such as growth rates, might be quite misleading, as they do not reflect the unprecedented structural changes that have taken place during transition. If in the 1980s growth was actually largely achieved by the production of the wrong goods which were distributed among customers in accordance with the plan, then it is scarcely a matter of regret that production of such goods has ceased due to a lack of demand. For decades the country experienced over-investment, which contributed to artificially high growth rates, implying low efficiency of fixed investment.

Frequent revisions of historical data and remaining inconsistencies in the statistics released by different agencies are other obstacles for analysts. Various agencies responsible for data collection quite often release different values for the same indicators. As statistics provide the background for decision-making, the problem of measurement is one of the topical issues for transition economies. Although the main objective of this paper is not to criticize various government agencies responsible for data collection, but to concentrate on some qualitative aspects of Russian enterprise and bank restructuring, comments on the reliability of statistics are made when they seem relevant.

4.2 Macroeconomic climate and microeconomic performance: current trends and selected problems

It is widely accepted that Russia's future depends on industrial performance and on country-wide improvements in management. It is also well recognized that economic growth can scarcely be achieved without new investment, restructuring and renovation of the capital stock. In fact, in 1997 the average age of equipment in industry exceeded 15 years while the share of newly installed equipment has fallen substantially (the share of equipment in industry aged under five years dropped to 8 per cent of total equipment in 1996 from nearly 40 per cent in 1970). Thus, Russian manufacturing cannot compete without massive replacement of technologies in most sectors.

The absorption of liquidity by rapidly growing public debt remains one of the most immediate problems hampering both macroeconomic and microeconomic restructuring. Firms cannot borrow money due to high interest rates, interest rates remain high due to continuous government borrowing. Most of the banks are not particularly interested in lending to the real sector as government securities can guarantee higher rates of return at low risk. Firms (as well as other taxpayers) try to avoid paying taxes when possible, and the government is forced to borrow money to cover the fiscal deficit. This is a vicious circle that has still not been broken in Russia.

Nevertheless, and despite some mistrust of the statistics, it is clear that the real sector delivered positive growth rates in 1997. It is important to note the steady acceleration in growth in the autumn: according to official figures, industrial output was 4.2 per cent higher in December 1997 than in December 1996; the increases for November and October were 3.7 and 2.3 per cent, respectively, above the level of the previous year; while in the first half of 1997 industrial output increased 0.8 per cent relative to the same period of 1996. Official figures also show that output in the mining sector grew faster than in manufacturing in 1997 (3.0 and 1.8 per cent, respectively), reflecting the continuous expansion of exports of raw materials and energy resources.

Macroeconomic figures recently released by Goskomstat indicate that economic recovery slowed down in January-April 1998: real GDP did not change, although industrial output increased 1.2 per cent relative to the same period of 1997. The rate of decline of investment accelerated again, falling by 5.8 per cent over the same period.

TABLE 4.2.1

Real industrial output by sectors, 1990-1997
(Percentage change over preceding year)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Electricity	2.0	0.3	-5.0	-5.0	-9.0	-3.0	-2.0	-2.1
Fuel	-3.0	-6.0	-7.0	-12.0	-10.0	-0.8	-1.0	0.3
Ferrous metallurgy	-2.0	-7.0	-16.0	-17.0	-17.0	10.0	-2.0	1.2
Non-ferrous metallurgy	-2.0	-9.0	-25.0	-14.0	-9.0	3.0	-4.0	5.0
Chemicals	-2.0	-6.0	-22.0	-21.0	-24.0	8.0	-7.0	2.0
Machine building	1.0	-10.0	-15.0	-16.0	-31.0	-9.0	-5.0	3.5
Timber, woodworking, cellulose and paper	-1.0	-9.0	-15.0	-19.0	-30.0	-0.7	-17.0	1.2
Construction materials	-0.9	-2.0	-20.0	-16.0	-27.0	-8.0	-17.0	-4.0
Light industry	-0.1	-9.0	-30.0	-23.0	-46.0	-30.0	-22.0	-2.4
Food	0.4	-9.0	-16.0	-9.0	-17.0	-8.0	-4.0	-0.8
Total industry [a]	-0.1	-8.0	-18.0	-14.0	-21.0	-3.0	-4.0	1.9

Source: Russian Federation Goskomstat.

[a] Including adjustments for non-recorded activities for total industry only.

Real industrial output increased in most sectors in 1997 (table 4.2.1). The oil and gas sector, heavily dependent on exports and thus on world market prices, performed relatively well, producing 291 million tons of oil, of which more than 40 per cent was exported. In the gas industry, a significant share of output was exported (some 36 per cent). The steep fall in world market prices for oil, however, had a significant impact on Russian macroeconomic conditions. Although exports of energy increased in physical terms, cash revenues were smaller than a year ago. Total exports in 1997 decreased by 2 per cent compared with 1996. Together with an increase in imports this contributed to a contraction of the current account surplus, especially in the autumn, which affected the financial markets.

Output in the machine building and metal processing industries grew by 3.5 per cent in 1997 compared with 1996, mainly due to a better performance in the automobile industry, which grew 12.6 per cent. Sales of domestically produced cars increased substantially in 1997 after Russian car makers reduced prices in the face of strong foreign competition. The growth in machine building reflected increasing domestic sales and rising household incomes. The strong growth of the automobile industry stimulated, in turn, production in ferrous metallurgy and compensated for the decline in revenues from ferrous metals exports. In fact, ferrous metallurgy output increased 1.2 per cent, while in non-ferrous metals the growth rate was higher (5 per cent) due to the continued expansion of exports.

Even light industry and food production, which had previously shrunk substantially due to strong competition from imports, showed some signs of recovery. Although food production fell slightly in 1997 compared with 1996, output in the industry was increasing towards the end of the year; in December 1997, for example, it was 7.3 per cent higher than in the same month of 1996.

TABLE 4.2.2

Allocation of loss-makers among large- and medium-scale enterprises by sectors, 1996-1997
(Per cent and billion "old" roubles)

	1996		*1997*	
	Per cent [a]	*Losses*	*Per cent* [a]	*Losses*
Industry	42.7	41 749	47.3	53 896
Construction	35.0	3 167	40.1	3 945
Transport	57.6	11 977	58.7	13 836
Agriculture	74.5	22 776	79.8	32 046
Total	55.5	79 669	60.4	103 723

Source: Russian Federation Goskomstat.

[a] Loss-makers as a percentage of the total number of firms in each sector.

It is important to note that, according to Goskomstat, the number of enterprises that faced financial difficulties in 1997 increased compared with a year earlier, despite the growth in output. Goskomstat figures show that the profits of large- and medium-scale enterprises in industry, construction, agriculture and transport decreased in 1997 in nominal terms to R82.1 trillion ("old" roubles) or $14.3 billion. This includes such giants as Gazprom, a number of big oil companies, some other export oriented enterprises in metallurgy, the chemical industry, etc. The figure seems to be surprisingly low for such a big country as Russia.

It has been reported that there were 26,000 profit-making firms among registered large- and medium-scale enterprises in Russia. In addition, 39,500 enterprises were reported to be loss-makers by the end of the year. The first group of enterprises (profit makers) earned R185.8 trillion or $27.5 billion, which also appears to be rather low. Losses of the second group reached R103.7 trillion ($15.3 billion). In general, such a performance could indicate that there has been little change at the enterprise level, despite the increase in industrial production in 1997. Table 4.2.2 shows the distribution of loss-makers among broad sectors of the economy.

TABLE 4.2.3

Profits in Russian Federation[a] enterprises by sectors, 1991-1997
(Billion "old" roubles)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Total	362.8	5 622.8	40 763.3	80 442.5	250 599	124 989	..
of which:							
Industry	221.3	4 015.3	27 159.5	52 706.1	154 458	84 143	82 409
Construction	23.2	249.2	3 119.3	9 408.2	22 718	21 545	10 612
Transport	20.9	269.1	4 056.7	11 181.2	37 104	25 372	16 820
Agriculture	53.1	454.4	3 062.0	-73.0	2 417	-22 847	-27 764
Trade	15.6	127.4	1 174.9	1 172.3	14 629	7 532	..
Other	28.1	507.4	2 190.9	6 047.7	19 273	9 244	..

Source: Russian Federation Goskomstat.

[a] As reported by firms.

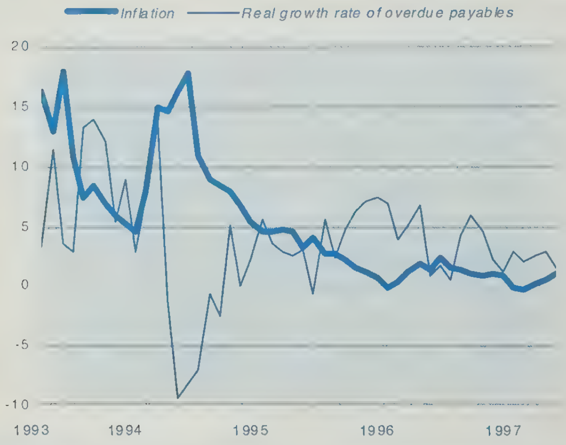
As can be seen in the table, the share of loss-making firms among large- and medium-scale enterprises increased in 1997 relative to the preceding year, and it is notable that this was the case in each sector. One half of the losses originated in industry. If these figures are considered alongside other macro-indicators, they give rise to more puzzling questions. How could it be that nearly 40,000 large enterprises have continued to operate with such huge losses? What kind of economy has developed, given that the government is unable to subsidize so many firms? Against the background of such a massive fall in firms' earnings, how is it that real disposable incomes increased by 3.5 per cent in 1997 and unemployment decreased? How can this be reconciled with growth in real wages of 4.3 per cent, and in consumption of goods and services (measured by retail sales) of 2.5 and 3.7 per cent, respectively, which indicates a much better performance?

In theory, the growth in activity in small businesses could compensate for falling household incomes from large enterprises, but in 1997, according to Goskomstat, small enterprises contributed only some 7 per cent to the total output of goods and services produced in the entire economy. If this is true, then obviously it would have not been enough to increase household incomes substantially and compensate for falling revenues from large-scale enterprises. Moreover, according to official statistics, nearly 20 per cent of small enterprises were also loss makers in 1997.

Officially reported profits have declined steadily in nominal terms since 1995 in most sectors of the economy (table 4.2.3). This contraction has occurred against a background of rapidly growing arrears, other money substitutes and various kinds of bills of exchange, and an expanding GKO market, which absorbed cash from the money market (during 1996-1997 the stock of payables increased in real terms 2.3 times). The stock of GKOs in circulation in 1996-1997 increased in real terms 4.6 times.

CHART 4.2.1

Inflation and real growth rate of payables, 1993-1997
(Percentage change over preceding month)



Source: Russian Federation Goskomstat.

Although such a policy allowed inflation to fall (chart 4.2.1 shows an inverse correlation between inflation and increasing arrears measured in real terms), it practically disconnected money flows between the enterprise sector at one end and the banks and the government at the other end. In such an environment banks were mostly serving the government, not the real sector. In turn, demonetization of the real economy affected tax collection. As can be seen from the official statistics, all types of arrears (tax, inter-enterprise, wage, etc.) have grown in the past several years.

It is not surprising that the stock of tax arrears began growing rapidly in real terms mostly in 1996-1997. By the end of December 1997 the stock of tax arrears exceeded R162 trillion, and the stock of non-payments to social security extra-budgetary funds had reached practically the same level (R152 trillion). Together these two figures are comparable to Russia's rouble M2 which is calculated by the central bank (the Central Bank of Russia's official M2 does not include hard currency accounts and dollars circulating in Russia).

The arrears issue has been one of the most pressing problems for the Russian government for several years. At the same time, however, the authorities themselves had established a self-perpetuating mechanism of arrears in the form of regulations which were introduced to solve fiscal problems. Former Russian Prime Minister Chernomyrdin admitted: "we wanted to make the situation better, but it turned out as usual". In brief, if a firm did not pay taxes on time it was charged penalties which were very high in real terms since the penalty rate was introduced during a period of high inflation and was not changed when inflation went down. Thus, the stock of penalties (additional to the stock of tax arrears) by the end of 1997 substantially exceeded the stock of official tax arrears. These regulations further disadvantaged firms as money appearing in a firm's bank account would be unconditionally transferred to the state budget if the firm was indebted. Thus, as firms could not control their funds, they had no incentive to put money into bank accounts (at least not in Russian banks). Moreover in a long queue of firm's "creditors" the state is first, while banks, the real creditors, are at the end of the list of creditors.

It appears as if the real economy was continuing to operate without cash flows, and it is surprising that it has shown some signs of recovery in 1997. Analysis of other macroeconomic data suggests that there may be another money substitute (apart from arrears and bills of exchange), that may in fact serve as money. It is well known that firms can use United States dollars circulating in Russia to pay each other. Some empirical evidence indicates that Russian firms possibly used hard currency to pay each other not only in Russia but also abroad through foreign banks. Before discussing these issues it seems relevant to look briefly at the balance of payments, which, despite the usual misgivings about data, reflects changes in the relationships of Russian firms and banks with the rest of the world.

4.3 Balance of payments and capital flight: how Russian money can be used abroad

After the global financial crisis affected the Russian markets in autumn 1997 many experts considered the Russian rouble to be another possible candidate for speculative attack. That could create serious problems for the Russian banking sector. The country's ratio of short-term debt to international reserves at the beginning of 1998 was practically the same as in Thailand, Malaysia and Indonesia. This threat has, perhaps, been exaggerated as Russian markets are still much more insulated from global markets than those in the south-east Asian countries. Moreover, financial markets in Russia are still separated from the real sector in the sense that the government securities market is dominant and absorbs cash. For the period of the crisis this can be considered as an advantage for Russia, because recent financial market volatility has not affected the real economy. In the long run, however, such a chasm between financial markets and the real economy would seem to be one of the major constraints on growth.

TABLE 4.3.1

The aggregated 1997 balance of payments: revised and prior revision

(Million dollars)

	QI	*QII*	*QIII*	*QIV*
Current account				
Prior revision	4 061	16	-1 045	..
Revised	3 798	6	-990	528
Financial and capital accounts				
Prior revision	-1 369	1 338	4 277	..
Revised	-1 130	1 941	2 102	1 019
Net errors and omissions				
Prior revision	-2 692	-1 354	-3 232	..
Revised	-2 668	-1 946	-1 112	-1 547

Source: Central Bank of Russia.

After the financial crisis reached Russia the warning signals came from the balance of payments and the current account in particular. The most recent official balance of payments data (for 1997) were released by the Central Bank of Russia (CBR) in May 1998. Prior to that some bank and investment fund experts had attempted to reconstruct Russia's quarterly balance of payments and had concluded that the country's current account surplus was shrinking rapidly. Those estimates were largely based on figures previously issued by the CBR, which appeared to be unreliable. After the CBR released balance of payments data for the whole year, the quarterly figures for January-September were revised substantially (table 4.3.1).

Russia's balance of payments is presented in table 4.3.2. Russia still had a current account surplus in 1997, but it was much smaller than in 1996. It is possible that the current account will remain positive in 1998 as well, despite the predictions of many analysts that it will be negative in the near future. In fact, the current account was positive in the first quarter of 1997 ($3.8 billion), very close to zero in the second quarter, and negative in the third quarter (-$1 billion). There is no doubt that low oil prices are likely to have reduced Russia's export revenues, but there is another issue which gives rise to doubts about the foreign trade statistics of 1997-1998. According to recent analysis, (Bureau of Economic Analysis (1998)), both the central bank and Goskomstat have overestimated Russia's imports in 1997 and, consequently, underestimated capital flight.

At any rate, some decline in imports can be expected in 1998 as well. The commodity structure of imports shows that imports of machinery and equipment contributed more than one third of Russia's total imports in 1997. In fact, imports of machinery and equipment had increased substantially in the autumn, partly because investment was really picking up (imports of that commodity group increased 26.3 per cent in 1997). But

TABLE 4.3.2

Balance of payments of the Russian Federation, 1994-1997
(Billion dollars)

	1994	*1995*	*1996*	*1997*
Current account	9.3	7.9	12.1	3.3
Goods and services	11.2	11.3	17.36	12.1
Goods	17.8	20.8	23.1	17.3
Exports	67.8	82.7	90.5	88.7
Imports	-50.0	-61.9	-67.4	-71.4
Services	-6.7	-9.5	-5.7	-5.2
Exports	8.4	10.5	12.9	13.5
Imports	-15.1	-20.1	-18.7	-18.7
Investment incomes and compensation of employees	-1.8	-3.4	-5.29	-8.4
Current transfers	-0.1	0.04	0.02	-0.4
Capital and financial account	-8.9	–	-4.0	3.9
Capital account	2.1	-0.3	-0.5	-0.8
Financial account	-10.9	0.3	-3.5	4.7
Direct investment	0.5	1.7	1.7	3.8
Portfolio investment	0.1	-1.6	9.7	46.2
Other investment	-11.6	9.5	-16.3	-43.4
Reserve assets	0.1	-9.3	1.4	-1.8
Net errors and omissions	-0.4	-7.9	-8.1	-7.3

Source: Central Bank of Russia.

TABLE 4.3.3

Alternative estimates of the exports and imports of the Russian Federation, 1995-1997
(Billion dollars)

	Exports			*Imports*		
	Customs Committee	*Goskomstat*	*CBR*	*Customs Committee*	*Goskomstat*	*CBR*
QI/1995	18.1	18.6	18.9	10.1	13.0	12.9
QII/1995	19.1	20.6	20.1	11.2	14.2	13.9
QIII/1995	19.3	19.4	20.2	11.7	15.3	15.2
QIV/1995	21.9	22.5	22.4	13.7	18.5	18.1
1995	78.4	81.1	81.6	46.7	61.0	60.1
QI/1996	19.4	20.4	20.9	11.7	14.9	16.2
QII/1996	20.7	21.6	21.9	12.3	16.3	17.0
QIII/1996	20.5	21.7	21.9	11.7	15.5	16.9
QIV/1996	24.3	25.4	25.7	10.9	15.6	17.3
1996	84.9	89.1	90.4	46.6	62.3	67.4
QI/1997	20.3	20.9	21.2	10.6	14.2	15.1
QII/1997	19.3	20.0	20.7	12.1	16.0	17.1
QIII/1997	20.5	21.1	21.7	13.8	17.7	18.3
QIV/1997	24.7	25.4	25.2	16.0	19.7	20.8
1997	84.8	87.4	88.7	52.5	67.6	71.4

Source: Central Bank of Russia, Customs Committee, Goskomstat.

such large increases were also caused by the government's intended abolition of tax exemptions for importers of investment goods from 1998, an announcement which obviously stimulated importers' activity in the autumn of 1997. It is quite probable, therefore, that total imports will decrease in 1998, thus compensating for falling export revenues. Moreover, early indicators for 1998 show that investment fell again in January (by 9.5 per cent) relative to January 1997.

It is also relevant that in the second half of 1997 the Customs Committee "improved" the quality of registration of imports. Following inspection by the Federal Security Service of the Ministry of Internal Affairs, the number of violations (such as bribes for not registering imports, lowering the prices of imported goods in customs declarations, etc.) decreased substantially. Thus "visible" or registered imports increased. For example, the Customs Committee reported that in the fourth quarter of 1997 imports increased by nearly 50 per cent relative to the fourth quarter of 1996. As this is difficult to reconcile with the general economic situation in the country, a more likely explanation is that imports were registered more fully in the autumn of 1997. Thus, the level of adjustments for non-recorded imports should be substantially smaller than before. Alternative calculations by the Bureau of Economic Analysis suggest that Russia's current account should in fact remain positive in 1997-1998.

There is another factor that allows for more optimism in respect of the balance of payments. Balance of payments statistics are originally released by the central bank, although foreign trade data, which do not reflect unrecorded imports (smuggling, "shuttle business", etc.), come from the Customs Committee. The central bank and Goskomstat make their own adjustments to Customs Committee figures, arriving at quite different figures in some years (table 4.3.3).

There is no major difference between the CBR and Goskomstat data for 1995; for both imports and exports the values of each set of data are very close. The main problem arises for 1996 imports when the difference is quite significant, the CBR's figure exceeding that of Goskomstat by some $5 billion. The CBR's import value for 1996 is 45 per cent higher than that released by the Customs Committee; January-September 1997 figures are also significantly different (by $2.5 billion).

Goskomstat and CBR foreign trade statistics officially coexist and it is in fact questionable which one is better. However, Goskomstat's adjustments may have stronger support from some other indicators: they allow for an indirect estimate of unrecorded imports by comparing retail sales, domestic production, the share of imported goods on domestic markets, etc. Thus, if foreign trade data in the official balance of payments are replaced by Goskomstat figures, the picture should be quite different.

Table 4.3.4 presents a "modified" balance of payments where foreign trade data have been estimated by the Bureau of Economic Analysis (BEA) using the methodology based on statistics of exports to Russia from foreign countries. As might be expected, BEA and Goskomstat foreign trade figures appear to be closer to each other than to the data of the central bank.

TABLE 4.3.4

Reconstructed balance of payments of the Russian Federation, 1994-1996

(Billion dollars)

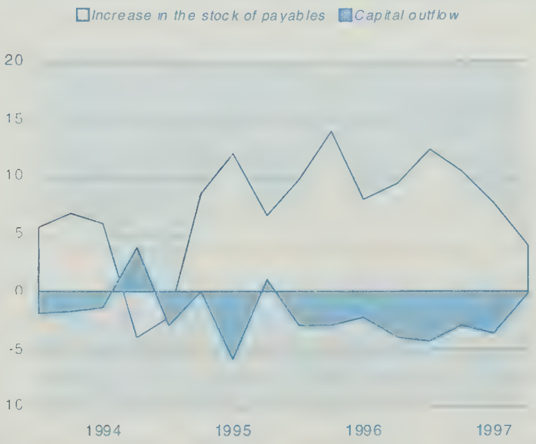
	1994	*1995*	*1996*
Current account	10.3	9.8	17.6
Goods and services	12.2	13.1	22.9
Goods	18.9	22.6	29.2
Exports	67.8	82.7	90.5
Imports	-49.0	-60.1	-61.2
Services	-6.7	-9.5	-5.7
Exports	8.4	10.5	12.9
Imports	-15.1	-20.1	-18.7
Investment incomes and compensation of employees	-1.8	-3.4	-5.3
Current transfers	-0.1	0.04	0.02
Capital and financial account	-8.9	–	-4.0
Capital account	2.1	-0.3	-0.5
Financial account	-10.9	0.3	-3.5
Direct investment	0.5	1.7	1.7
Portfolio investment	0.1	-1.6	9.7
Other investment	-11.6	9.1	-16.3
Reserve assets	0.1	-9.3	1.4
Net errors and omissions	-1.4	-9.8	-13.6

Source: Central Bank of Russia, Customs Committee, Goskomstat.

CHART 4.3.1

Quarterly capital outflows and increases in the stock of payables, 1994-1997

(Billion dollars)



Source: Russian Federation Goskomstat; Bureau of Economic Analysis.

One of the implications of these exercises and comparisons of Goskomstat and CBR figures is that capital flight in 1996 may have been larger than officially presented by the CBR. The item called "net errors and omissions" is in fact capital flight. Throughout the last few years it has had the same sign and has been too big to be regarded as containing the usual statistical errors. The higher value of capital flight in 1996 might be closer to reality, however, especially when it is borne in mind that markets were very nervous in 1996 prior to the presidential elections. Thus, the central bank's figure for capital flight should be considered as a lower bound of the outflow of money from Russia. The reconstructed current account figures using Goskomstat or BEA foreign trade data for 1997 and 1998 (see estimates in table 4.3.4) look more optimistic, although it is obvious that capital flight should be larger in those reconstructed versions of the balance of payments.

Another important implication, which comes from the analysis of the above-mentioned tables, is that in 1997 capital flight ("net errors and omissions") was largely financed through foreign capital (compare the capital and financial accounts for 1997 and previous years). In 1997, the current account surplus was smaller than "net errors and omissions", while previously it was larger. Supposedly, prior to 1997 export revenues were largely kept in foreign banks, while perhaps in 1997 Russian firms and banks started exporting capital, which came from foreign investment.

It is also interesting to mention that "net errors and omissions" are negatively correlated with changes in the stock of payables (chart 4.3.1). This suggests the hypothesis that in order to avoid paying taxes and penalties Russian firms carry out money transactions with each other offshore.

In fact, chart 4.3.1 shows that the stock of arrears was falling, or at least not growing as rapidly as before, when capital was flowing back to Russia (as in the fourth quarter of 1994). It is clear that macroeconomic conditions are far from ideal: existing regulations encourage firms to put money in offshore accounts rather than in Russian banks, and to engage in illegal transactions hidden from the Russian tax authorities.

At any rate, exported Russian money can be considered as working capital which is maintaining economic activity in the country. It is clear that Russia has returned to some kind of "dual" monetary system as was the case in Soviet times. Legal rouble money of enterprises (previously it was the so-called non-cash money which was hard to change for cash) is now largely replaced by barter, arrears and hard currency held offshore. At present, the dollarization of the Russian economy facilitates economic activity and the government should be rather cautious in attempting to break this mechanism as it may damage the economic system, which, though imperfect, is functioning. It cannot be guaranteed that a new and better mechanism can be created. In the short run, dollar transactions are an important fact of firms' behaviour, but in the long run, they may be a serious impediment to sustainable growth.

In fact, a massive inflow of foreign capital is not to be expected in the next few years (because of lingering uncertainty in the financial markets in 1998, and potential uncertainty in 1999 and 2000 caused by the elections). Thus, the growth of investment is likely to be rather moderate and to come mainly from domestic sources.

Stabilization of the GKO market and a reduction of interest rates remain, therefore, among the top priorities of government economic policy. There is, however, another obstacle to investment and growth: the rather peculiar Russian banking sector, which has largely stayed apart from the real economy.

4.4 Russian firms: some aspects of firms' behaviour

At present, the Russian authorities consider the enterprise sector primarily as a "taxpayer" rather than a "producer" of goods and services. As fiscal issues dominate government policies and the tax burden remains rather heavy, firms attempt to escape from the clutches of government by establishing a specific environment hidden from the authorities. Thus, as has been mentioned, Russian firms are actually operating in an environment where legal rouble money turnover is largely replaced by illegal offshore transactions among firms, arrears and barter, so that the money of enterprises is largely separated from money in the rest of the economy. Moreover, due to arrears and barter, relative prices can scarcely be called equilibrium prices.

In general, a distortion arises when firms set arrears prices for the mutual settlement of indebtedness which are higher than they would have been in a normal macroeconomic environment. On the other hand, barter reduces prices. Under existing regulations, however, firms cannot easily sell their products at lower than cost price: although not prohibited, the resulting losses should be taxed (firms have to pay VAT and profits tax). If a customer-firm obtains some intermediate product by barter (cheaper than normal price) and sells the final product for cash, this means that it should sell it at a price below cost. In order to avoid sanctions from tax inspectors it has to continue the barter chain; otherwise it will be heavily taxed and definitely become a loss maker. Such regulations obviously stimulate capital outflow and illegal offshore payments.

Remaining price distortions, which arise from existing cross-subsidization, also affect firms' behaviour. In fact, if the prices for electricity, gas, transportation, etc., are much higher for firms than for households or some selected group of privileged enterprises, it means that the burden is quite unevenly distributed across the economy. Moreover, energy prices for the private sector are higher than for state owned enterprises.

It is to be expected that the elite of Russian business is represented by companies in the energy sector (see tables 4.4.1-4.4.3 showing various types of ranking of companies). Energy sector enterprises do not face most of the problems that are typical for manufacturing. The energy sector was able to gain from the very beginning of transition when, due to relative price adjustments and the rapid growth of energy prices, they could accumulate more money than the rest of the real economy. Export opportunities were also much

TABLE 4.4.1

Top 10 Russian enterprises by sales, 1996

(Billion roubles and million dollars)

	Sales	
	Billion roubles	*Million dollars*
RAO "UES of Russia" *(electricity)*	116 758.4	22 782.1
GAZPROM *(gas)*	115 536.0	22 543.6
LUKOil *(oil and oil products)*	44 015.0	8 588.3
SIDANCO *(Siberian Far-Eastern Oil Company)*	26 567.0	5 183.8
YUKOS *(oil)*	23 600.0	4 604.9
SurgutNefteGaz *(oil and gas)*	23 519.0	4 589.1
AVTOVAZ *(car manufacturing)*	19 906.2	3 884.1
TATNEFT *(oil)*	18 758.0	3 660.1
SIBNEFT *(oil)*	17 500.0	3 414.6
BASHNEFTEHIM *(oil, petrochemicals)*	17 428.4	3 400.7

Source: "Top 200 Russian Enterprises", *Expert,* No. 38 (106), 6 October 1997 (Moscow).

TABLE 4.4.2

Top 10 Russian enterprises by profits, 1996

(Billion roubles)

	Profits	
	Before tax	*After tax*
GAZPROM	45 091.0	33 215.0
RAO "UES of Russia"	11 049.2	8 378.6
SurgutNefteGaz	5 069.9	4 114.5
LUKOil	4 733.0	3 842.0
"Diamonds of Russia –Sakha"	3 550.1	1 616.8
TATNEFT	2 243.3	1 594.7
ROSNEFT	2 198.0	1 708.0
BASHNEFT	1 704.3	1 197.7
Norilsk Nickel	1 523.0	1 164.0
AVTOVAZ	1 469.7	1 013.2

Source: "Top 200 Russian Enterprises", *Expert,* No. 38 (106), 6 October 1997 (Moscow).

TABLE 4.4.3

Top 10 Russian enterprises by market value, 1996

(Billion roubles and million dollars)

	Capitalization	
	Billion roubles	*Million dollars*
GAZPROM	135 795.9	23 292.6
RAO "UES of Russia"	95 100.9	16 312.3
LUKOil	93 570.6	16 049.9
YUKOS	54 031.5	9 267.8
SurgutNefteGaz	38 898.9	6 672.2
SIDANCO	35 286.9	6 052.6
SIBNEFT	31 648.2	5 428.5
SLAVNEFT	27 068.3	4 642.9
MosEnergo *(electricity)*	22 313.8	3 827.4
RosTeleCom *(telecommunications)*	20 543.7	3 523.8

Source: "Top 200 Russian Enterprises", Expert, No. 38 (106), 6 October 1997 (Moscow).

greater for oil and gas exporters. It is certain that some strong commercial banks were established on the basis of energy sector money.

Continuing shifts in relative prices have meant that the energy sector has become a net creditor of the rest of the economy. Most manufacturing technologies in the country were (and still are) extremely energy intensive and they could not be replaced without investment. Thus, manufacturing enterprises, as well as public sector organizations, are net debtors to the energy companies. Recent decisions to regulate natural monopolies and introduce some price restraint may help to reduce inflationary pressure in the short run, but cannot solve long-term problems (restructuring, increase in efficiency, etc.). As the adjustment of relative prices is not complete, freezing a distorted price structure can give the wrong signals to economic agents thus impeding structural adjustment.

With their obvious advantages, energy sector enterprises could easily establish cooperation with their partners and grow into large companies integrated with banks. These companies deal with extraction of energy resources, refining, sales and exports. It has been much more difficult to attract capital to the manufacturing sector. After the dissolution of the ministerial structure and privatization, the manufacturing sector was less successful in establishing vertically integrated structures that could successfully compete in the market. According to official figures, 70 per cent of GDP is produced by the private sector, but despite that fact, the shares of only some 150 enterprises are traded on the stock exchange. These are mainly energy enterprises, telecommunication companies and a few other firms from the rest of the economy.

As was noted above, manufacturing firms have found it difficult to attract money from the banks for investment (with some rare exceptions). Several microeconomic problems still remain at the enterprise level, including weak management skills, poor marketing, the inability to negotiate successfully with foreign investors, and so on. The existing enterprise accounting system, which was inherited from the past, is a major obstacle to attracting foreign investment since it is quite difficult at present for foreigners to understand the financial situation of a particular firm from its accounts. (The financial situation is also distorted by barter, arrears and hidden activities.) The introduction of international accounting standards and practice at the enterprise level should be considered as one of the top priorities of government in respect of economic performance.

There is another important fact, originating in the growing stock of arrears, which is not very much stressed at present. Inter-enterprise relationships between debtors and creditors are currently very informal, and as a result the stock of inter-enterprise arrears is growing rapidly as bankruptcy law is not in fact being used. A few sectors, namely natural monopolies, remain net creditors for the rest of the economy, while a lot of firms are net debtors to the government. This implies that if in the future the bankruptcy laws are actually implemented, a new wave of reallocation of property can be expected in Russia. Previously privatized firms can in principle be again nationalized (if indebted to the government) or they can fall under the ownership of other creditors, such as natural monopolies, which are mainly energy and transport companies.

4.5 The banking sector and its role as an intermediary between savings and investment: were there any changes in 1997?

The banking sector plays a key role in a market economy by serving as an intermediary between savings and investment. The modern Russian banking sector was established in the early 1990s and at present consists of the central bank and commercial banks. The number of banks grew rapidly in the early stages of the reform period, although their number includes both banks which operate at present and banks whose licences have been recalled but which have not been formally closed. In 1996 the number of registered banks and non-banking credit institutions remained relatively stable at around 2,500. During 1997 the number of banks in operation decreased by 15 per cent (from 2,029 to 1,719 between 1 January 1997 and 1 December 1997).

In the early 1990s, bank growth took place in an environment of high inflation and negative real interest rates (see chart 4.5.1). Banks were largely crediting each other and the real sector, which needed short-term credits to pay wages and increase working capital. At that time banks could obtain cheap (in fact, subsidized) credits from the central bank and gain funds from speculation on the interbank market. The regulations existing at that time made it rather easy to start a banking business, and thus the number of banks rocketed in 1992-1993.

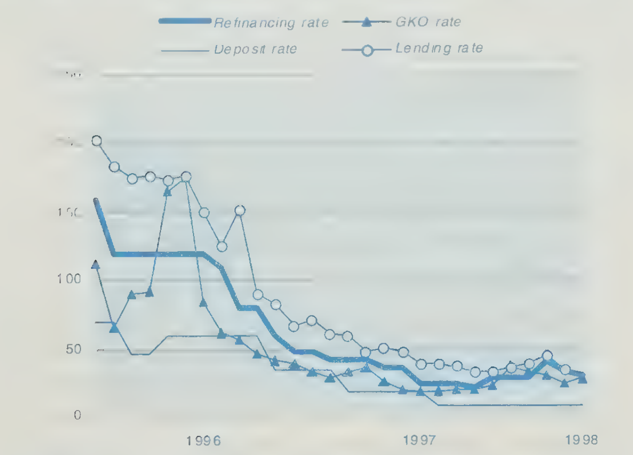
The next stage in the development of the banking system in Russia occurred in 1994 and the first half of 1995. After refinancing interest rates were raised in early 1994 to positive levels, banks switched their activities from the interbank credit market to the hard currency market. This shift was also required by the expansion of foreign trade – increasing exports and the growing demand for hard currency from importers.

The change in fiscal policy gave birth to another segment of the financial market when the government abolished direct borrowing from the central bank and began issuing government securities. In the second half of 1995, a special corridor for exchange rate fluctuations was introduced by the monetary authorities and the government in order to set some limit on the profitability of speculation in the hard currency market. It helped to peg inflation and switched money flows to the GKO market, which began expanding rapidly. As at 1 March 1998, the stock of GKOs in circulation reached R402.3 billion (new roubles) which is equal to the country's rouble M2.

CHART 4.5.1

Interest rates in Russia, 1996-1998

(Per cent)



Source: Central Bank of Russia.

As was noted above, during each of these three periods banks had no incentives to work with the real sector, and thus they were not able to develop skills for evaluating investment projects and risks in the real sector. Up to the present, most banks have had no need of this business since profits from speculation have been much higher than any earnings expected from financing fixed investment projects in the real sector. The share of long-term credits provided by the banks to the economy varied between 3 and 9 per cent of total credits. Most banks have not developed credit risk analysis departments that could investigate investment opportunities. There are, however, enough indications that some banks (mostly in the provinces) are subject to strong pressure from local authorities to give credits to particular enterprises. Thus the number of bad debts remains high in the Russian banking sector, which further discourages lending to the real sector, as the banks seek other opportunities to cover their losses.

Although some banks were set up initially with an orientation to the real economy (like MENATEP, INCOMBANK and some others) they subsequently shifted their activities towards financial markets. Banks have been much more eager to provide credit for foreign trade activity that could guarantee high rates of return and timely repayments.

In 1997, banks began buying the shares of enterprises more actively, seeing future opportunities to exercise more control over the economy. After inflation fell in 1997, in turn pulling down interest rates, commercial banks slightly expanded their activities in the real sector. Those activities were also stimulated by the appointment of Chubais and Nemtsov as first deputy Prime Ministers in the new government of March 1997. Immediately after this the stock market began expanding rapidly: by October 1997 the RTS index had tripled. Foreign capital inflows increased and led to substantial changes in the structure of the consolidated balance sheet of the commercial banking sector. In fact, there appeared to be some signs that the commercial banks were becoming involved in the recovery of the real sector.

Some of the indicators characterizing banking sector performance in 1996-1997 can be seen in table 4.5.1. Claims on private sector enterprises in nominal terms increased in January-October 1997 by nearly 40 per cent, while during the whole of 1996 they grew by only 24.5 per cent. In 1997 there was rapid growth of credit in real terms (inflation in January-October 1997 was only 9 per cent, while in 1996 it was 22 per cent). At the same time, lending to the government slowed down: while in 1996 net claims on general government increased 140 per cent, in January-October 1997 they grew by only 33.5 per cent. These positive developments were halted at the end of the year by the global financial crisis, which affected Russian markets. Banks started selling their stocks and purchasing hard currency.

During 1997, Russian banks expanded foreign activities, increasing their foreign assets. A number of banks penetrated global financial markets, receiving internationally recognized ratings from the main rating agencies.

From table 4.5.2, which shows some indicators of the top 10 Russian banks, it can be seen that one bank dominates in Russia: this is Sberbank, which in Soviet times was the only bank dealing with the population at large. Its inherited infrastructure and traditions have ensured that it remains the largest bank, whether measured by assets, deposits, or profits. The bulk of household savings is deposited in Sberbank, which is also the main holder of government securities. During the late 1997 financial crisis Sberbank was in a rather safe position as its main role at present is to serve as an intermediary between household savings and government spending (the stock of securities held by Sberbank is approximately equal to household deposits). Sberbank works like a pump which forces money to circulate from households to the government and back. Again, it is noteworthy that this turnover largely occurs outside the enterprise sector.

It can also be seen from table 4.5.2 that the assets of the other banks are rather small by international standards. For example, the total assets of INCOMBANK or Russian Credit are some $5 billion each, while the assets of the rest are much smaller. In general, the Russian banking system consists of Sberbank as a special case, 10 other relatively big banks, and a great number of medium-sized and small banks.

The level of relative prices in Russia has moved very close to international standards and in some cases exceeded them. This is also the case for prices of investment goods. Moreover, it is expected that new investment will be used for importing relatively modern western technologies, replacement of obsolete equipment and renovation of the capital stock. It is clear that

TABLE 4.5.1

Selected indicators of Russian commercial banks, 1996-1997
(Billion roubles)

	1 January 1996	*1 July 1996*	*1 January 1997*	*1 July 1997*	*1 November 1997*
Reserves	36 712.3	37 198.6	48 301.0	52 742.8	60 175.4
Foreign assets	46 149.4	52 662.3	73 747.2	72 020.2	81 688.7
Claims on general government	62 638.5	93 402.7	150 945.2	187 348.0	201 567.1
Claims on non-financial public institutions	62 460.4	74 980.5	80 211.4	86 847.7	80 860.4
Claims on private sector enterprises	133 786.8	148 189.5	166 517.4	197 047.4	232 697.2
Claims on other financial institutions	525.0	1 473.8	242.0	99.6	509.2
Demand deposits	69 331.9	74 705.7	92 378.9	113 011.1	133 301.7
Time deposits	124 496.6	149 641.9	169 751.5	187 176.7	192 653.9
of which:					
In foreign currency	55 255.7	63 460.3	72 386.9	74 844.8	81 043.1
Money market instruments	11 858.5	16 472.7	26 652.8	22 810.7	23 239.7
Foreign liabilities	29 969.8	39 685.5	60 663.4	71 612.2	107 099.3
General government deposits	9 741.1	11 768.9	12 141.6	21 759.7	25 223.5
Credit from the CBR	8 005.1	8 758.2	12 768.7	10 556.2	11 413.2
Capital accounts	66 687.8	92 250.1	124 834.0	142 643.7	149 663.0
Other *(net)*	22 181.5	14 624.4	20 773.2	26 535.4	14 903.7

Source: Central Bank of Russia.

TABLE 4.5.2

Top 10 Russian commercial banks as at 1 January 1998
(Million roubles)

	Net assets	*Liabilities*	*Credits*	*Securities*	*Household deposits*	*Profits*
Sberbank	172 169.5	139 464.7	36 395.7	102 207.5	106 917.6	4 163.3
Vneshtorgbank	18 437.5	11 576.7	11 764.9	4 641.1	382.1	897.1
UNEXIMBANK	21 779.1	17 701.4	13 900.7	4 021.5	27.8	609.2
National Reserve Bank	10 059.1	6 649.7	3 566.7	6 579.4	17.4	323.4
INCOMBANK	31 975.4	26 234.9	15 368.2	6 084.8	1 652.5	588.3
CBC-Agro	25 174.7	21 598.9	9 266.3	10 269.9	3 141.9	188.8
International Industrial Bank	15 414.2	12 777.7	11 963.2	602.8	3.8	73.5
GAZPROMBANK	9 997.0	8 529.5	6 165.7	2 144.0	569.7	436.3
MENATEP	20 904.2	16 962.3	11 468.8	3 161.8	685.3	432.5
Russian Credit	29 952.8	18 162.6	10 690.5	1 731.6	348.2	74.3

Source: "Top 200 Russian Banks", *Dengi (Money)*, No. 10 (164), 25 March 1998 (Moscow).

Russian banks are unable to finance big investment projects simply because they do not have enough liquidity, their assets are small and they cannot exceed risk norms.

A further tightening of fiscal policy will allow the maintenance of low inflation and a strengthening of the role of monetary policy and the role of the banks. Such a policy mix should result in remonetization of the economy which will cause a growth of M2 in real terms. In turn, this will increase banks' assets and their ability to advance credit to the real sector. At present, monetary policy can be seen mostly as an adjustment tool. Distorted financial markets, mainly the GKO market, do not leave much room for manoeuvre and, in fact, determine monetary policy. Thus real interest rates remain high, and lending to the real sector is not a priority of the banks.

In order to keep financial markets under control, the monetary authorities at present can only use rather crude, albeit effective, methods. For instance, in order to resist pressure on the rouble, the central bank increased the refinancing rate to 42 per cent in February 1998. At the same time, the authorities increased the reserve requirements for hard currency accounts to 11 per cent, making them equal to the reserve requirements for rouble accounts. According to various analysts this move has created serious problems for some 30 of the well-known Russian banks which, during the crisis, were selling roubles and stocks and accumulating hard currency.

Most of the banks are registered as Moscow based banks, although they are spreading their activities to the provinces more and more, and some mergers between Moscow and provincial banks are likely in the near future (with Moscow banks dominating). It is also quite possible that the number of financial industrial groups will increase, and that a closer alliance will develop between banks and the manufacturing sector.

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Discussion of chapter 4

Silvana Malle, OECD[106]

The somewhat positive developments in the Russian economy in 1997, particularly in the second half of the year, provide the background for the themes discussed by Gavrilenkov. The international financial crisis, the effects of which have grown increasingly dramatic following foreign investors' suddenly awakened perception of Russia's weak fundamentals for sustainable growth, are only briefly discussed in this paper. Nevertheless, the paper still provides very valuable insights for understanding the most recent developments and worries concerning Russia's future.

Russia resumed growth in 1997. But, while growth looks very modest indeed, its sources are unclear and the outlook remains fragile. The revised growth estimate released in April 1998 is 0.8 per cent, slightly above the 0.4 per cent earlier estimated, due to corrections in statistics starting from 1996. In the second half of 1997 domestically financed investment and restructuring in some branches of the economy also turned out to be positive. Output started increasing in oil and gas, machine building and metal processing, the car industry, ferrous and non-ferrous metallurgy, food processing and in some branches of light industry. A pick-up in domestic demand, due to increasing disposable incomes and real wages, was reflected in decreasing unemployment and increasing consumption. There are not yet reliable data on economic performance in the first quarter of 1998 (which may well turn out to be negative in the aftermath of the persisting financial crisis and interest rates developments).

Available data for 1997 also show concomitantly decreasing profits (including in gas and oil companies), an increasing number and volume of loss-making activities and increasing payment arrears. Trying to make sense of apparently contrasting developments – the resumption of growth and a pick-up in domestic demand, while total profits fall – Gavrilenkov argues that official statistics produced by both Goskomstat and the central bank overestimate imports and underestimate capital flight, since on the one hand Goskomstat adjusts only partially for poor data from the State Customs Committee, and the balance of payments, on the other hand, does not provide a full detailed accounting, since only "errors and omissions" take stock of actual capital flight. What Gavrilenkov suggests is that Russian companies have an interest in sending money offshore, to conceal their mutual transactions and earnings from the tax authorities. Thus, while capital inflows have been increasing in 1996 and 1997, much of the attracted hard currency still flows abroad in support of tax-avoiding activities carried out by both firms and banks.

While there is no doubt that Russian statistics, much like statistics in many other transition economies, and in spite of remarkable improvements since 1992, are still full of flaws, Gavrilenkov's very interesting insights need to be corroborated by robust evidence at the microeconomic level: an area open to further research and, hopefully, better monitoring from official statistics. The fact that total profits have been falling, while the economy was modestly picking up, does not necessarily reveal a major failure of central statistics, although the recent changes in Goskomstat's management and accusations levied against the improper use of companies' balance sheets might, indeed, if proved, support this hypothesis. One could argue, on the one hand, that large-scale privatization in Russia did not lead to significant changes in management. The balance sheets of enterprises, as Gavrilenkov also suggests, are difficult to read. With enterprises' balance sheets distorted by barter, payment arrears and the use of money surrogates, understanding the effective performance of companies is, indeed, difficult, not only for foreign investors, but for any interested private or public agency. The importance of this issue is often neglected not only in Russia, but also abroad. Incidentally, while the work and ability of the Security and Exchange Commission has no doubt improved over the years, one should not bet on the accuracy of the balance sheets of the Russian companies listed in Russian Stock Exchanges. Overall, few enterprises have gone bankrupt during the years of transformation. It is not unlikely that most enterprises are, indeed, loss-making. In Russia losses will be reflected in increasing tax and other payment arrears. Profits, if there are any, are likely to be used to increase wages in the still widespread employees-run factories. On the other hand, profits may, indeed, be greatly underreported. Firms with positive profits have an incentive to report zero profit, while loss-making firms report losses. In almost every region in the Russian Federation, the sum of profit taxes collected divided by the profit tax rate gives a number that is inconsistently large compared with the reported profits of the region by Goskomstat. However, Gavrilenkov's conclusion that reported profits are low because they are channelled abroad, requires more robust evidence. On the one hand, most of the firms that report zero profit or losses to Goskomstat are not the same firms that have high export earnings and foreign subsidiaries. On the other hand, there is, indeed, some microeconomic evidence of offshore transactions by joint ventures. All in all, Russian capital outflows cannot be explained only by tax avoidance. Political and economic instability, as well as a poor institutional framework for business, are the causes behind the low level of foreign direct investment (FDI). Even after some large-scale transactions which attracted foreign capital in 1997, FDI remains modest (about $4 billion cumulative to 1997) and quite below the levels attained in more successful transition economies. While part of Russian capital outflows can, in fact, turn into inflows for tax payment purposes, when pressed by emergency tax administration measures in the short run, or attracted by investment opportunities, one should not neglect the more profound reasons which lead both foreign and domestic capital to be hesitant about investing long term in Russia, despite some success in macro-stabilization policies.

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[106] The opinions stated are those of the author, and do not necessarily reflect those of the OECD.

The issue of large-scale tax avoidance, which underlines the concerns for sustainable growth in Gavrilenkov's paper, should also be addressed by looking at the behavioural implications of the existing framework of tax policy and administration. While it has become a ritual to ascribe tax evasion to large-scale companies, and in particular to those operating in the energy sector, which no doubt are major tax delinquents, pervasive tax evasion calls for a more profound reassessment and revision of the existing tax system. This system is characterized by an excessive number of taxes, excessive administrative complexity of tax declaration procedures, instability and fairly widespread arbitrary practices by tax inspectors. Emergency tax measures, often enacted in Russia, may, indeed, be one major cause for tax avoidance activities, including capital flight. A major recommendation of OECD's *Economic Surveys*: *Russian Federation, 1997* was, indeed, the adoption of a simplified and reasonably stable tax system.

Tax payment arrears from large-scale companies also need to be addressed on a wider scale. While in many OECD countries, energy prices are higher for the household sector than for business, in Russia, the opposite is true, thus leading to a situation in which final consumers are formally subsidized at the expense of production sectors. The same sectors accumulate payment arrears to the energy sector, which, in turn, are reflected in the tax payment arrears of the energy sector to the federal budget. What all this amounts to, in fact, is the ongoing subsidization by the state of energy consumption, a vicious circle which can only be interrupted by effective price adjustments. While this should be simple in theory, it requires major innovation in practice, since most households do not have energy consumption meters: providing them is a difficult but not impossible task, which the Samara local government has already undertaken.

Developments in the banking sector from 1996 to 1998 were not so much characterized by the rapid growth of credit in real terms to the non-financial sector, but rather by the increasing purchase of state bonds and corporate securities. The main buyer of Russian State Debt Securities is the State Savings Bank, which is also the main holder of households' deposits. Although banks do not extend long-term credit to enterprises, their financial situation cannot be considered free from risk. Gavrilenkov's paper does not provide a full assessment of the pros and cons of the recent developments in the banking sector, nor does it discuss the institutional framework needed for a proper functioning of banks as financial intermediaries. Russian banks, mostly the large ones, have increased their holdings of government and corporate securities to compensate for the fall in profits which followed the introduction of the exchange rate band in April 1995, since the stabilization of the rouble decreased the demand for, and hence the profitability of, servicing exchange operations.

Thus, the widely held expectation in government circles that banks would start extending long-term credit to the real sector once anti-inflationary monetary and exchange rate policies put an end to the benefits from speculative currency operations, proved to be wrong. It is also far from clear that banks are aiming to become active shareholders by acquiring in the market (or, more easily, through the shares-for-loan scheme badly managed by the government at end-1995) the controlling bulk of shares. While trends in the financial industrial groups suggest that banks, at least the most important ones, are aiming at corporate control which could help to improve corporate governance, it cannot be excluded that portfolio concerns are also playing a major role. At any rate, with the crash of the Russian stock exchange under the waves of the international financial crisis, the whole banking sector appears to be now even more fragile than some years ago. All this should draw attention to the major underlying factors which work against a robust pick-up in investment in Russia, such as short-term and volatile liabilities, the absence of an institutional framework providing security for creditors, and uncertain collateral and contract law enforcement in general. While the State Savings Bank enjoys the state guarantees of deposits, the commercial banks have not managed to build up a framework for deposit insurance. All in all, even if improved bankruptcy provisions have been approved, the state still enjoys a privileged position among creditors as a consequence of its desperate search for tax revenues. Incredible delays in approving a meaningful Land Code work against a real estate market and the use of land as collateral. But, finally, and most worrying, the judicial system is not able to cope with contract enforcement, a *sine qua non* condition for the functioning of market economies.

In the aftermath of the financial crisis the central bank, so far, has proved itself able to counteract pressures to depreciate the rouble (although the struggle is not yet won). The sharp increase in interest rates is an additional burden on the federal budget and concern at the possible development of a debt spiral, stressed in the OECD survey of the Russian economy, has now become even greater. While it is correct to focus on the immediate need to put order in the tax system and in tax collection, it is unlikely that these measures alone will cure the ills of the Russian transition economy. The immediate need now is to replenish the state coffers with cash from the privatization of large-scale companies in the energy and utilities sector, a decision which has been long delayed by the Russian government but which has now become inevitable, although it will be more costly than it would have been if taken earlier. With the import of know-how and managerial skills and a focused demand for institutional change from abroad, Russia still has a chance to recover and put herself on a path of sustainable growth. It is, of course, up to the Russian government to take the necessary steps. If this becomes manifest, the international community cannot but be supportive.

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CHAPTER 5

A CASE STUDY: THE CZECH PRIVATIZATION AND SUBSEQUENT STRUCTURAL CHANGES IN CAPITAL OWNERSHIP AND PROPERTY RIGHTS

Pavel Mertlík[107]

5.1 Introduction

The restructuring of banks and enterprises, and the relationship between these two sectors, constitute an appropriate framework for the discussion of some of the most important problems facing the Czech economy today. On the one hand, large Czech banks have acquired significant ownership rights in industrial and other non-financial enterprises. On the other hand, the non-financial enterprise sphere is heavily indebted to the banking sector. The problem can be looked at from either angle, especially since they are responsible for many of the other problems currently faced by the economy.

The results of the privatization accomplished so far in the Czech Republic cannot be understood only from the statistical records. It is necessary to analyse the structure of property rights and of corporate governance that emerged during and after the privatization process. As a result of the formal privatization process, the majority of large- and medium-sized enterprises fell under the control of investment funds (IFs). There are a number of important exceptions, but the general rule is that the "standard" Czech enterprise is now controlled by a group of IFs. So, the question of the disposition of property rights for the dominant part of the Czech economy is effectively transformed into one about the arrangement of property rights in the IFs.

My paper focuses on the enterprise side of the problem and I emphasize four points. First, the purpose of privatization is to create an institutional framework within which there are incentives for individuals and groups to foster greater economic efficiency. This was the thinking behind the government's privatization programme, but implementation proved to be more complicated than expected by the designers of the policy. At the beginning of the transition it was believed that large-scale and rapid privatization would smooth the passage from public to private property rights. This was only partly successful, because although there now exists a clear system of private property rights in formal terms, this is still accompanied by a system of public corporate governance. In other words, part of the transition problem is the lack of a clearly defined system of corporate governance to correspond to the new structure of private property rights. This problem has many aspects which I discuss below.

My second point concerns the cost of privatization. The Czechoslovak economy prior to 1990 was highly concentrated. There were just a few but very large state owned enterprises. During 1990-1992, these big units were generally divided into many small units, sometimes to an excessive degree. Following the completion of the privatization programme, many of these small economic units were combined often into structures and sizes resembling their state owned predecessors. The process was very costly and involved large transaction costs. Large capital investments were channelled into this process of reconcentration and withdrawn from areas of real productive investment where they might have led to faster growth.

The third point concerns the nature of the new owners that emerged during voucher privatization, and in particular in the post-privatization period when property rights were restructured. During this latter period two types of investors emerged: the first was essentially composed of speculators and the second were mainly long-term strategic investors. The speculators were typically domestic capital investment funds and also some small local or foreign financial groups. The process of economic reconcentration which they engendered was clearly driven by speculative motives without any new real investment or other benefits for the economy. The long-term, strategic investors were usually transnational or foreign companies. The privatization process, however, is an unfinished process and the structure of ownership is still changing very quickly.

And fourthly I stress the role of the banks within the new ownership structure of the corporate sector and conclude that their role has been more positive than many critics allow.

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5.2 Investment funds

(i) Definitions

IFs are special public limited companies established by banks, insurance companies, consultant firms, and various other private companies (mostly but not exclusively financial), and by physical persons. The precondition for establishing an IF was to be able to provide it with equity capital of at least CZK 1 million. IFs, just like other public limited companies, issue shares; in the voucher privatization they issued shares against receipt of investment vouchers, although they also issued shares against other "standard" forms of equity invested in the IFs by their founders at the time of their establishment. According to the current legal regulations, IFs are established as daughter companies of investment companies (ICs), which are intermediate financial institutions with a mandatory standing between the founders of IFs and the IFs themselves and serving as administrators to the IFs. In the Large Privatization, IFs used the investment vouchers collected from the public to "purchase" the shares of corporatized former SOEs. One IF could own up to 20 per cent of the shares of any one enterprise according to the regulations ruling at that time.

(ii) The first wave of the Large Privatization (1990-1992)

The promotional campaign of some of the IFs in the first wave of the Large Privatization – about 260 were established in the first wave but only about 12 became really large holders of vouchers – was based on the promise that they would buy back their own shares from the public (i.e. from their shareholders) after one year for at least 10 (but possibly 15) times the initial price that the shareholders had paid for their investment vouchers. This promise was the major incentive for the public to participate in the voucher scheme; as a result the mass of people realized that the vouchers and the shares they could obtain for them represented something really valuable, that they were real property. As a result, 82 per cent of Czech adults registered as investment voucher holders (each one receiving a voucher booklet containing 1,000 investment points for a nominal fee of CZK 1,035 which, at that time, was about one fifth of the average monthly wage; the book value of the stock offered for one voucher booklet was about CZK 40,000 in the first wave of the Large Privatization). About 5.95 million of the first wave investment voucher holders placed 72.2 per cent of their investment points into one or more IFs, while the remaining 27.8 per cent of investment points were used directly for investment in the shares of enterprises.

(iii) The second wave of the Large Privatization (1993-1994)

In the second wave of the Large Privatization, the voucher privatization activities of the IFs and their acceptance by the public were already established and the IFs repeated their success from the first wave.[108]

Thus, almost overnight, IFs became new actors of considerable importance on the domestic economic scene. Through their participation in the voucher scheme they became key owners of an important part of the Czech economy, holding decisive property stakes in most voucher privatized enterprises. However, their role soon proved to be highly conflictual and controversial. The core of this controversial role of the IFs was intrinsic to their "unfortunate" institutional set-up. IFs were strange financial holdings in that, on the one hand, at least some of them were trying to play the role of active and responsible owners; on the other hand, as institutions for collective investment, they had duties towards their small shareholders (clients), namely, to grow, to maintain the market prices of their own shares and to generate dividends. While the first role implied the behaviour of an active (direct) investor, the second required a passive (portfolio) type of investment behaviour. This double role was embedded in the unusual (i.e. as compared with collective investment institutions and instruments in the developed market economies) legal classification of IFs as public limited companies: their clients are in the position of shareholders, that is, they are co-owners of their IF with the same formal legal position as other shareholders: in short, they are co-entrepreneurs in the same sense as partners or shareholders in any other company, with similar rights and obligations, powers and responsibilities. They are therefore not simply depositors, as would be the case if they had invested in mutual funds and similar collective investment institutions where the owners and/or administrators of the fund have a fiduciary duty vis-à-vis their clients. In spite of this arrangement of property rights in IFs, which *eo ipso* logically excludes a privileged position (protection) of small shareholders, the IFs and their managers, however, do have a fiduciary duty towards their small shareholders, both legally and morally.

Another crucial factor, closely related to the double role of IFs mentioned above, was the strategy of the founders (and hence the dominant owners) and/or administrators of IFs, including the reason why they established their IFs in the first place; namely, whether their primary aim was to concentrate packages of shares of privatized companies in order to establish ownership control over them, or to serve the investing public by providing collective investment instruments.

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[108] However, the legislation had meanwhile introduced open and closed mutual funds as a new collective investment instrument, and during the second wave of Large Privatization mutual funds played an important role and were thus partly substituted for IFs.

This controversial nature of IFs, as both core enterprise owners (direct investors) and collective investment institutions (portfolio investors), and the related differences in the strategy of IFs' dominant owners or administrators, were the main reasons for the subsequent differences in the behaviour of individual IFs which, soon after their inception, had to choose which of the two roles would be given priority. The outcome was that there quickly emerged two types of IFs with different goals and strategies. The industrial and financial IFs which decided to behave like holding companies were soon trying to find various ways of circumventing the 20 per cent ceiling on their ownership share in a single company; on the other hand, the 20 per cent ceiling seemed to be too high from the perspective of risk averse fiduciary administration of the collective investments of small portfolio investors. The development of property rights soon after the completion of the voucher privatization demonstrated that the existing regulation of IFs (and, more generally, most of the existing regulations and rules governing capital market institutions) was inadequate. Consequently, all the agents involved – namely, the managements of privatized enterprises, IFs, banks and other institutional founders of IFs, and small investors – began to seek changes in the existing regulations, the need for which was more and more recognized in the political sphere.

(iv) Change in the regulation of IFs in 1996

The desired change in the regulation of IFs was made in mid-1996. The rules governing the behaviour of IFs were significantly tightened, forcing them to follow the "traditional" strategy of a collective portfolio investment institution. However, before these new rules came into force, IFs were allowed to choose between either continuing to operate as a legal IF (and thus to be subject to the new, more severe rules requiring a traditional portfolio investor's type of behaviour), or to transform themselves from IFs into "ordinary" public limited companies and hence avoid being subject to the collective investment regulation. Numerous IFs took advantage of this opportunity and transformed themselves into industrial holdings.

Although the legal status and regulation of IFs is still far from perfect – in particular, there was no change in the legal status of IFs' clients as shareholders, although their transformation into mutual funds would have been a desirable and logical part of the reform – the change in the regulation in mid-1996 was important because it made the situation in the collective investment area, and in the capital market generally, much more transparent than previously. Instead of two types of IFs with different behavioural patterns, there are now basically two distinct types of institution with much more clearly defined objectives, and this in itself is to the benefit of investors by reducing an area of uncertainty. Since the industrial holdings are not subject to the collective investment regulations, they are able to invest and control enterprises in the manner of direct investors without the necessity of circumventing the IFs' regulatory restrictions through various informal or semi-legal practices.

The legislative change in mid-1996 thus increased transparency in the areas of property rights and the capital market but, from the point of view of the process of the post-privatization restructuring of property rights in the Czech economy (see below), the solution unfortunately came *post festum*.

(v) Further institutional change in 1998

Another change in the institutional status and ownership rules for IFs was recently made in early 1998: first, the existing IFs (i.e. those that were not turned into industrial holdings) will have to be transformed into open mutual funds and it is expected that when this is done they will have to sell company shares from their portfolio *en masse*; and secondly, the amendment of the banking act forces banks to get rid of a large part of their property stakes in the non-financial corporate sector and to establish a "Chinese wall" between the commercial and investment banking divisions of the universal banks. These two changes are likely to have a considerable influence on the ownership structure of the Czech economy. The practical outcomes of these new developments, however, are yet to be seen and it is therefore premature to try to assess the effects here.

5.3 Capital concentration

(i) Major factors behind reconcentration

(a) Conflicting roles of IFs

Another principal feature that emerged from the Large Privatization via the voucher method was that from the very beginning the new ownership structure was highly fragile and unstable. The main source of this intrinsic instability was the conflict between the two roles of the IFs discussed earlier. It was difficult to see how they would be able to fulfil their second role of fiduciary care of their clients' deposits when the capital markets were chronically depressed, because of a large excess of supply over demand, when market prices of securities were generally low, and when most enterprises were making low profits and paying out small or zero dividends. The only legal way to earn returns and satisfy shareholders (and, not least, creditors, particularly in the case of the domestically owned, private non-banking IFs that were heavily indebted to the banks) was to sell parts of the portfolio.[109] This was unavoidable because of the suboptimality and low quality of all the IF portfolios where, as they emerged from the process of voucher privatization, the shares of voucher privatized enterprises were naturally dominant and other, more liquid assets such as bonds, bank deposits, etc. were marginal. The problem of the IFs was thus not simply one of the management and quality of their portfolios but the need for a fundamental restructuring. In practice, the shares which were offered for sale in the secondary capital market by the IFs were of course the few "good" shares for which a steady market demand existed. But in principle, the IFs were – and are – willing to sell any shares from their portfolio if they receive a good offer.[110]

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[109] I ignore here illegal or morally questionable ways of producing dividends, such as removing resources from controlled enterprises, for which the slang expression "tunnelling" became common during 1996-1997, and also cases where the dominant owners or administrators of IFs actually defrauded their clients.

(b) Individual shareholders

Small individual shareholders – former voucher holders – have also been gradually revealing their liquidity preferences and selling their shares; this behaviour was later on strongly influenced by the negative developments in the capital market and in the economy as a whole. Moreover, in 1996-1997 foreign portfolio investors, for several reasons, sold their shares and left the Czech capital market in large numbers. Finally, the last, but not the least, important agent persistently selling in the market has been the government which still has a considerable number of small holdings (remainders) in hundreds of companies that are being gradually placed on the market. In addition, the government has started to privatize the "strategic enterprises" which have remained in its long-term portfolio according to previous privatization plans.

(c) Capital flight

Last but not least, it should be mentioned that the privatization efforts of the government have increased with the growing budgetary problems of the Czech economy since 1995, and also with the shorter terms of office held by the government; the behaviour of the cabinet in late 1997, and again in the spring and summer of 1998, recalled the outspoken "privatization night" of Mr. Meciar's second cabinet in Slovakia during its last session prior to the expected no-confidence vote. All these phenomena have contributed to the long-term excess supply and depression in the capital market.

(ii) Subsequent changes in the structure of ownership

Given all the above facts, it is understandable that the five-year process of formal privatization determined the preconditions for the subsequent process of restructuring or redistributing property rights. This latter process, sometimes referred to as the "real privatization" (in contrast to the formal process), seems to have peaked in 1995-1996; it had started (according to some market agents) during 1994 and continued with reduced intensity during 1997. It consisted of a wave of acquisitions of Czech enterprises that proceeded by concentrating the shares of privatized enterprises previously held by small shareholders, and/or from the secondary capital market, in the hands of direct investors or intermediary companies. A large part of the Czech enterprise sector, privatized through the voucher scheme, in this way has become controlled by a majority or dominant owner. The largest packages of shares of Czech companies, however, have been traded almost exclusively outside the organized capital markets, as direct deals over the counter of the Securities Centre; this is one of the reasons why this process of capital concentration has been charged with a lack of transparency. A much more important negative characteristic of the concentration process, however, is the fact that the minority shareholders have suffered from a lack of protection of their rights: after the concentration of formerly dispersed property rights in a company, the company as a rule "goes private", i.e. its shares practically (although usually not formally, at least for a while) cease to be traded in the organized markets and rapidly lose their market value. The lack of protection of minority shareholders[111] (and of companies against hostile takeovers) provided a favourable environment for this restructuring of secondary property rights.

(iii) Results

(a) Economic costs

It is somewhat ironical that as a result of this process of reconcentration of Czech industry there re-emerged more or less the very industrial structure that had existed before privatization in the form of SOEs or, in the 1980s, of national corporations. The strength of the traditional industrial and corporate networks inherited from the centrally planned past was analysed and described in the early 1990s by Gerald McDermott (1993a and 1993b) who saw the survival of these networks for sourcing, subcontracting, sales and distribution as evidence that the reform process had not gone deep enough: as relics of the old "hierarchy", these old networks, administratively designed and inefficient, should have been removed by the "market". However, I would argue instead that the reconcentration of industry along these earlier lines, which is most apparent in some of the large and powerful industrial groups which have been formed in the post-privatization period, for example, in the engineering and chemical industries, proves the rationality of these older industrial structures. Their re-emergence, in my eyes, not only proves their viability but raises questions about the sense, efficiency and costs of the excessive deconcentration that resulted from privatization and, specifically, the voucher experiment. The whole process of deconcentration and reconcentration of course was not cost-free – on the contrary, there have been enormous direct and indirect social "transaction costs". The "winners" of the whole operation are the individuals and groups that provided the various intermediation services required to bring about the shifts in property rights. The "losers" are those who have borne the costs of the whole experiment: industry, enterprises, and society as a whole (as taxpayers). Billions of Czech koruny were spent on these processes but there was little real (tangible and intangible) capital investment (as opposed to financial investments) or other useful social outlays. While the costs of voucher privatization were enormous, its social benefits are negligible (if any).

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[110] This however does not apply to those IFs that function as industrial or financial holdings.

[111] There was no legislation at all to protect the rights of minority shareholders in the Czech Republic until mid-1996.

(b) New owners

Who are the new dominant company owners, and what are the incentives they face? The answer to these questions can only be tentative since, as already emphasized, a lack of transparency has been a key feature of the whole process of the post-privatization restructuring of property rights. From the records of ownership stakes in companies which have been published regularly by the Securities Centre since 1996, the researcher can obtain the names of the direct owners, but can get no information about the ownership structure of these direct owners themselves if they are not quoted in the same record. Moreover, in the situation where numerous companies are owned by other companies, with often complicated ownership chains and interrelationships, an outsider can only obtain very limited relevant information from the publicly accessible sources.[112] The dominant ownership influence in a company may also be exercised through a group of smaller direct owners with a common ownership background.

Nevertheless, it can be asserted, mostly on the basis of press reports, that the new direct investors are either companies or capital (including financial) groups interested in the long-term development of the acquired company, or speculative groups interested in reselling it after a short period, or in generating revenue from asset-stripping. In the first – largely positive – case the investor may be a company specialized in the same or related field, or a capital or financial group interested in inserting the newly acquired company into its own capital (or financial) structure. These two cases can be seen as distinct types of strategic investment and they mostly respond to the development needs of the acquired company (although cases of hostile takeovers with the aim of liquidating or marginalizing a competitor do of course exist as well). In all of these possible cases, including the speculative ones, the acquiring company may be foreign or domestic; and in the process of restructuring property rights there have been frequent battles between domestic and foreign capital groups for the control of a company, one consequence being a large increase in the share price of the targeted company. In many other cases, however, the process has been seen as the "cheap sale of the national economy", a possibility foreseen by some critics of voucher privatization in the early 1990s.

The behaviour of the speculative investor during the wave of acquisitions was typically based on the simplest of strategies: to sell the controlling package of the acquired company for a higher price than the speculator had to pay for it in the capital market during the process of concentration (including of course all the transaction costs involved in the concentration process itself which, as a rule, were quite significant).[113] The strategy was based on the belief that sooner or later there would emerge an interested strategic investor (or another speculator) willing to accept the speculator's offer. In cases where this expectation was disappointed (and they were not so rare) various forms of asset-striping were the usual way for the speculator to cover his costs.

(iv) Role of the banks

Voucher privatization – the core of the Czech privatization model – together with the process of transforming and/or establishing financial intermediaries and the emergence of the new "grassroots" private sector, has facilitated the process of creating strong domestic capital groups concentrating large property shares in their hands and also expanding their economic activities abroad. In the Czech Republic such groups have emerged around a number of large banks, and also around several large industrial and trading companies that, as a rule, were themselves privatized within the Large Privatization.[114] Besides these cases there are also some entirely private financial groups, most of them with a somewhat unclear financial background, that were started from scratch during the privatization years. An important role in the formation of all these capital groups has been played by ICs and IFs and by the entire financial infrastructure that had formed around the voucher experiment. This development emerged in the Czech economy due to the concurrence of two factors: (i) the economy was strong enough in terms of the amount of capital assets that had been accumulated in the country before the privatization started, and simultaneously (ii) the privatization process was based on the recombination of property rights.

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[112] To illustrate this, imagine a hypothetical situation where company A is owned by company X and company B by company Y. If we do not know who are the owners of companies X and Y we cannot say anything relevant about the ownership relation between companies A and B: such a relationship may not exist and companies A and B may be independent; but it may also be the case that they have a common final owner, say, company M controlling companies X and Y, or company A may be the owner of company B through its ownership stake in company Y, intermediated by some other company, and so on – there are innumerable possible options.

[113] The description of this type of behaviour is based on the lecture given by Petra Wendelová in Prague in November 1996. Mrs. Wendelová has a rich personal experience of such activities from the period when she worked for Harvard Capital & Consulting.

[114] The exceptions are several (former) trade companies that already had the legal form of public limited companies in the 1960s. They were not privatized within the formal privatization process since they were already private companies. This was the case of one of the biggest capital groups in the country, Chemapol.

It is particularly the private IFs and private domestic financial groups (although various foreign speculators are also involved) that are active in the speculative and asset-stripping activities, including the direct removal of financial and tangible resources from enterprises under their control. On the other hand, the behaviour of domestic non-private (financial and non-financial) capital and corporate groups has so far been rather positive – for the most part, they seem to belong to the group of committed owners with long-term objectives for the development and market success of the companies in their group.[115]

Regarding the involvement of banks as owners in the Czech economy, which is often criticized as one of the sources of inefficiency in the Czech corporate sector, it is true that the banks as last-resort owners of industrial companies and at the same time the latter's principal source of loans, naturally do not evaluate investment projects and the credit demands of their companies in a fully independent manner. That means that there is an inherent internal conflict of interest between the banks as owners and investors, on the one hand, and as the prudent custodians of the fiduciary funds of their depositors and of their shareholders' interests, on the other. This has the possible negative outcome (assumed by some commentators to be very typical of the Czech economic reality today) that the banks may be financing their own enterprises under softer conditions than are available to other clients, and thereby enabling them to prolong their inefficient operations or delay their bankruptcy. By behaving this way the banks harm the interests of their depositors and shareholders, increase the volume of their own bad debts and undermine competition in the loan market.[116] On the other hand, the ownership-responsibility type approach of such banks vis-à-vis the enterprises under their control may also have strong positive economic effects: it may enable the enterprises to overcome more easily their potential financial and economic difficulties and, in particular, the banks, as owners with a long-run interest in the economic efficiency and market performance of "their" enterprises, may be more capable and willing to invest large sums in costly but challenging development projects, including long-term ones, than financially weaker, non-banking investors. The risk of criminal activity by banks as owners of enterprises is also substantially lower compared with various anonymous and non-transparent forms of private institutional ownership – such as non-banking investment funds with speculative or asset-stripping goals and an unclear financial background, as mentioned above.[117] The positive role of banks as owners of Czech companies (particularly with respect to their role in establishing effective corporate governance and exerting pressure to improve financial discipline in privatized companies) was recently noted, *inter alia,* by Claessens, Djankov and Pohl of the World Bank on the basis of their empirical research (1996).[118] On the other hand, banks as owners may be tempted to block the entry of new outside investors in order to retain ownership control over the enterprise. In such cases the banks' behaviour may slow down the development of the enterprises concerned.

It has been noted recently, however, (for example, King (1996); Mertlík (1996)) that the bank-based financial capitalism – with the government playing a major role as the core investor in the banking sector and thus in the whole economy – that has evolved in the Czech Republic with large industrial and financial groups typically centred around a bank or a large industrial enterprise or a trading company, resemble the German *konzern* or even the Japanese *keiretsu.* The relationship between the banking and the industrial and trade sectors seems to be one from which the industrial enterprise benefits rather than suffers. Nevertheless, the financial weakness and fragility of many of these financial groups, due to their undercapitalization and excessive credit burdens, seems to be the crucial factor in determining whether or not they will be successful in the future.

The dynamic process of restructuring the post-privatization enterprises has created a specific model of the distribution of property rights in the Czech Republic. The process is not yet finished, and there may still be various surprises to come, but the specific mode of privatization that the government chose has had a crucial impact on the subsequent restructuring of enterprises in industry, and of manufacturing in particular.

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[115] The statement about the speculative nature of the private IFs and private financial groups compared with the non-private or quasi-private ones (originating in the former publicly owned sector), however, refers more to the smaller ones among them, and of course not to all such groups. There are also private financial groups – the biggest and strongest ones particularly – which behave as responsible and committed owners.

[116] This type of criticism has been widely made by politicians and the media, but also by some economists; in some cases the criticism reflects the interests of TNCs that were either not successful in the "post-privatization acquisition battle" with Czech capital for the control of these companies, or simply see these Czech companies as rivals and seek political ways of weakening their position in the market.

[117] In addition to the criticism of the banks discussed above, large Czech banks (particularly recently) are also blamed for forcing the enterprises over which they exert control to take credits which the enterprises do not need, sometimes at interest rates exceeding the market ones, or preventing them from looking for cheaper financial sources outside their "mother" bank. The evidence for such behaviour by the banks is rarely provided however by such critics. Empirical analysis of the structure of company financing and of the role of credit, conducted by the Institute of Economics of the Czech National Bank (Buchtíková (1996, 1997), Buchtíková and Čapek (1997)), and based on a large set of company panel data for the years 1993-1995, do not support the existence of such kinds of bank behaviour and bank-enterprise relations.

[118] While many economists criticize the ownership of Czech enterprises by the banks as an inefficient configuration of property rights and corporate governance, leading to conflicts of interest between the banks as creditors and as owners, resulting in efficiency losses in both the enterprises and the banks, a recent empirical study based on panel data for several hundred of the largest Czech enterprises (Claessens, Djankov and Pohl (1996)) concludes that the banks, as investors and owners in the Czech Republic, have significantly improved the economic performance of the enterprises in which they have ownership stakes, and that this highly concentrated, bank-controlled sector is, compared with other forms of ownership (namely, the corporate sector controlled by private non-banking IFs), the most successful one in the Czech economy.

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Discussion of chapter 5

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We have listened to a very interesting and at the same time an occasionally puzzling paper, that raises challenging questions on three points.

- The legacies of the past have to be understood so as to understand the present.

Explaining the process of post-privatization concentration in the Czech Republic, Pavel Mertlík mentions that the industrial structures that had existed before privatization – i.e. former big SOEs – have re-emerged and along with them the traditional industrial and corporate networks inherited from the centrally planned economy. This, he says, only shows the rationality of these structures. Had one anticipated such a reconcentration, it would have been possible to avoid the huge transaction costs of voucher privatization, which turned into a "public bad" as opposed to a public good. Hence the conclusion of the paper is surprising: what has been the "obvious" "crucial impact" of the Czech model of restructuring of the property rights? Has it been positive after all?

- The issue of property rights and governance.

Conventional wisdom in the field of economics of transition is that corporate governance should be improved in most if not all the countries in transformation. Whatever the privatization methods the most common pattern is generally the dominant insiders' ownership (except in foreign owned firms), while in western literature the superiority of dominant outsiders' ownership is usually stressed. In this respect, the Czech experience is considered as better than other countries', because, through really massive voucher privatization, SOEs have been transferred to new owners – new capitalists – and to independent, newly created, investment funds (IFs). Thus the Czech model is a case for outsiders' ownership whereas in many other countries insiders' privatization is dominant.

According to Pavel Mertlík, in fact, ownership has been transferred to private IFs on the one hand, which are genuine outsiders, and to "non-private owners" that are banks and bank-controlled IFs. The non-private owners, he says, have on the whole acted as insiders with long-run interests in the economic efficiency of their enterprises. One may ask two questions here. First, are "insiders", defined in such a way, better? Second, as we know that banks are all to be privatized, what will happen next, and how are the banks going to behave then, as "private owners"?

- What was the role of banks in the privatization process?

Pavel Mertlík stresses the positive role of the banks, going against the views of the majority of western economists according to whom the involvement of state owned banks in Czech enterprises resulted in inefficient property and corporate governance structures. He quotes the much publicized World Bank study by Claessens et al. (1996) that argued that on the contrary banks as investors and owners largely improved the performance of enterprises, while privately owned investment funds practised asset-stripping and speculation. Here we would have two questions. First, taking into account the fragility of the Czech banking sector, that was dramatically evidenced in the Czech crisis of 1997, can one really be as positive? Second, considering this role of the banks in the post-privatization period, can one remain so critical as to the voucher-type privatization?

CHAPTER 6

ENTERPRISE RESTRUCTURING IN EAST GERMANY

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6.1 Introduction

As in all transition countries, the economy in eastern Germany has been going through a deep crisis from the beginning. When, on 1 July 1990, the German Economic, Monetary and Social Union (GEMSU) came into force, the task to be tackled was to replace an economic system based on central bureaucracy and state ownership by a western-type market system. For that kind of economic transition there was no prototype at that time. Though most professional observers did not expect the economy of the German Democratic Republic to be able to withstand the competitive pressure from the west for a long time, it was not recognized that the eastern German economy was more or less bankrupt and the capital stock had to be built up from scratch. There was a widespread view that it would be possible to rebuild the economy in only a few years. The German Chancellor's promised "blossoming landscapes" reflects that early impression. However, it was not only the underestimation of the poor status of the eastern German economy that thwarted such expectations. Added to this were further impediments. First, the starting conditions were heavily hampered by particular conditions of the currency union. Setting the exchange rate of the mark against the deutsche mark at parity, which was politically motivated, resulted in a dramatic deterioration of the market position of east German suppliers. Secondly, as a result of the negotiations between unions and employers' associations, wages increased very fast and independently of productivity growth. This sharp wage increase raised unit labour costs to a level more than twice as high as in the west.

Overnight, the "transformation shock" laid bare the economic inefficiencies of the old socialist system. In the second half of 1990, gross value added was only half the level recorded during the first half of the year, and production also dropped significantly in 1991. Up to the present time, the reconstruction of the eastern German economy has been substantial: due to high investment the production potential has grown by about 6 per cent per annum (Sachverständigenrat (1997)). Production has been expanding since 1992, first at a quick pace, then more slowly. Gross domestic product (GDP) – in current prices – nearly doubled in 1997 compared with 1991. Productivity also expanded, very rapidly at first, not only because of the expansion of production but also due to extensive reductions in personnel. The pace of reduction was highest immediately after unification, the number employed declining from 9,747,000 in 1989 to 7,321,000 in 1991. Employment has continued to decline since 1992 but more gradually. The decline in unit labour costs was only insignificant, however, due to the strong increase in wages.

Nevertheless there is still a long way to go in attaining western standards of efficiency and competitiveness. By 1997, GDP per capita had only reached 58 per cent of the western German level, whereas wage and salary income per employee had risen to nearly three quarters of that in western Germany. Thus, unit labour costs were still about one fifth higher than in the west (table 6.1.1). Not only is the performance of the eastern German economy still poor, but also the extent of economic activities is unsatisfactory. In 1997 the new federal states contributed just 12 per cent to the total output of the German economy as a whole, while the region accounted for nearly 20 per cent of Germany's population. It is clear that it will take time for the gap between eastern and western Germany to be closed, but obviously the catching up has slowed dramatically. For 1998 it is expected that total output will expand by 2.4 per cent (at 1991 prices), whereas in western Germany the economy will grow by 2.8 per cent. In 1997, eastern German GDP had already expanded more slowly than in western Germany.

The process of adjustment in the first years after unification is not an indication of self-supporting growth, there being still a large gap between production and consumption. In 1994 (last available data) output reached only 60 per cent of internal absorption (consumption and investment). Extensive government support was transferred from the west to the east to close this gap, e.g. about DM 200 billion in 1994. This reflects the basic philosophy of German unification "to buy time" in order to bridge the period of adjustment.

The extensive transfers have contributed to an economic structure which has become rather more similar to an economy in reconstruction than to an economy which is integrated into the world economy. Taking the western German economy as a benchmark, two main differences are striking (table 6.1.2):

TABLE 6.1.1

Indicators of the economic catching up in eastern Germany, 1991-1997
(West Germany=100)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
GDP at current prices per capita	31.3	38.9	47.7	52.3	55.5	57.1	57.9
Gross wage and salary income per employee	46.7	60.7	67.9	70.4	72.0	72.8	73.8
Labour productivity [a]	31.0	43.5	53.1	56.0	57.8	59.3	60.9
Unit labour costs [b]	150.6	139.4	128.0	125.7	124.6	122.9	121.2

Source: Federal Statistical Office; calculations by the Institutes.

[a] GDP at current prices per employee.

[b] Gross domestic income per wage/salary earner divided by nominal GDP per gainfully employed.

TABLE 6.1.2

Structure of eastern German gross value added, 1990-1996
(Per cent of total gross value added)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*West Germany 1996*
Agriculture, forestry and fishing	4.5	3.3	2.6	2.0	1.6	1.6	1.7	1.0
Industry	47.2	36.1	33.9	31.8	33.3	33.0	32.7	32.2
Energy, gas, water supply and mining	8.1	7.6	5.3	4.6	3.7	3.1	3.1	2.2
Manufacturing	28.3	16.8	14.3	13.0	13.4	13.3	13.8	25.2
Construction	10.8	11.7	14.3	14.2	16.2	16.6	15.8	4.9
Trade and transport	18.9	14.1	12.9	12.0	11.4	11.1	10.8	13.6
Service enterprises	11.7	21.9	25.5	27.8	28.3	28.6	29.9	37.0
Government and households	17.7	24.6	25.0	22.9	21.0	20.3	20.3	12.9
Total gross value added	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Federal Statistical Office.

- For many years the construction industry was the pacemaker, benefiting from the necessity to rebuild public infrastructure, production and office buildings, and private housing. It contributes 16 per cent to gross national output, a share three times as high as in western Germany.
- On the other hand, manufacturing collapsed after unification and is still weak at the present time. In 1996, it contributed a mere 14 per cent to overall output, but assuming western German standards its share in overall production should be 25 per cent – almost twice as high. The intensity of manufacturing activity, calculated as employees per 1,000 inhabitants, was at 36 in 1997 and is still lower than in western Germany (86 employees per 1,000 inhabitants). Even in low industrialized areas, such as Schleswig-Holstein, manufacturing intensity is greater than in eastern Germany (52 employees per 1,000 inhabitants).

Since 1992, it seems that there has been a reversal of the downward trend in eastern German manufacturing. Production has expanded, at last, at respectable rates, and it is obvious that there has been substantial progress in the reconstruction of the manufacturing sector. However, the level of manufacturing activity is still much too low for a self-supporting economy, and thus the aim is to broaden the manufacturing base.

This paper examines the adjustment process in eastern German manufacturing. It raises the question of how this development is to be assessed: has there been a solid gain in competitiveness or is the actual development merely the short-term result of generous privatization and subsidy schemes? What are the obstacles to gaining competitiveness? Some economists argue that the level and the rise of unit labour costs are the main problem. Others take into account low productivity resulting from the inadequate capital stock of enterprises. Finally, some arguments emphasize an unsatisfactory integration into national, as well as international markets.

In order to discuss some of these questions, some general considerations on enterprise restructuring are developed first against the background of the privatization strategy of the Treuhandanstalt and the importance of subsidies to enterprises. Secondly, empirical evidence is presented concerning the development and actual situation in manufacturing. Data used in this section come from statistical offices. Aggregate data can only give a limited impression of the situation, as the adjustment process actually varies very considerably from one company to another. The core question is how the performance of companies has developed with regard to mode of formation, ownership structure, company size and industry. The investigation of adjustment processes on a micro-level is based on the various business surveys conducted by the Deutsches Institut für Wirtschaftsforschung (DIW) in eastern German manufacturing.

6.2 The twofold policy strategy for enterprise restructuring: privatization and subsidization

- Taking into account the poor competitiveness of the eastern German economy, it was obvious that without massive government support the process of unification could easily end in fiasco. A twofold policy for restructuring the eastern German economy was designed.
- On the one hand, it was clear that the government or a government agency would not be able to restructure and manage the old state owned companies. Rapid privatization was assumed to be the major precondition for successful restructuring.
- On the other hand, it was clear that the eastern German capital stock had to be built up from scratch. Massive subsidization of investment was assumed to give incentives to investors, i.e. companies from abroad as well as investors from eastern Germany itself.

The key role of transferring the socialist planning system into a market system was assigned to the Treuhandanstalt (THA), the state owned trust organization founded in 1990. It temporarily became the owner of about 8,000 companies with more than 45,000 plants; 33,000 shops, hotels, restaurants, pharmacies and cinemas; numerous buildings which once belonged to political parties, mass organizations and public administration; as well as 3.9 million hectares of agricultural and forest land. It had a very complex bundle of tasks which were not only economically motivated but also highly political. By law it was to privatize its assets as fast as possible, as privatization was considered to be "the heart of the transformation process" (Siebert (1990)). This task, however, included more than simply privatizing. The legislator also instructed the THA to restructure and break up companies in order to create smaller units, which are easier to privatize than bigger ones. At the same time the THA was supposed to acquire investment, to preserve and create jobs and to realize suitable proceeds from the sales. As there was no clear hierarchy of tasks the THA had to decide on its own priorities. It adopted as a basic rule the preservation of a company as far as possible. This also meant that it looked for investors who were willing and able to continue operating the company in question and to avoid selling to investors who were only interested in asset stripping (Breuel (1992)). To ensure that operating would be continued, the THA sold the companies under specific conditions such as commitments to jobs or investment. This strategy definitely restricted the range of potential investors.

TABLE 6.2.1

State of privatization in eastern Germany at the end of 1994

	Number	*Percentage*
I. Small privatization [a]		
Total objects	23 422	100.0
of which:		
Privatized	15 520	65.1
Liquidated or not privatized	8 172	34.9
II. Large privatization		
Total objects	13 815	100.0
of which: companies		
Completely privatized	6 321	45.8
Partly privatized	225	1.6
Reprivatized	1 588	11.5
Given to municipalities	265	1.9
Liquidated	157	1.1
Other objects	1 506	10.9
Remaining companies	3 753	27.1
of which:		
Offered for sale	192	1.4
Assigned for liquidation	3 561	23.6

Source: Ministry of Finance, BvS.

[a] Shops, restaurants, hotels, pharmacies, etc. Finished at the end of June 1991.

By the end of 1994 the THA was closed down as it had finished its work: about 75 per cent of the former state business was privatized (table 6.2.1). Most of the remaining companies were in liquidation and only a few – but some of the bigger ones – were offered for sale. The THA had contracted about 70,000 investors who promised about 1.5 million jobs and DM 187 billion of investment. Two thirds of jobs were to be retained or newly created by contract and one half of jobs were additionally penalized. The THA and its succeeding organization argue that – on average – employment and investment targets have not only been reached but even surpassed (Schmidt (1996)). Nevertheless, investment and job commitments were bought for a high price. It is assumed that in some cases they have been financed by the state 100 per cent, or even more (Lucke (1995)).

These results are very impressive, but it is also evident that selling thousands of companies in a very short time under the restriction of job and investment commitments must often have been accompanied by financial assistance. At least, this constellation weakened the selling position of the THA in most cases and thus led to a "low" price. As the THA operated under the conditions of "soft budget constraints" it was able to react in a flexible manner and to reduce the investors' risks by compensating in advance. Whatever the opinion is on the success of this specific way of privatization, the costs have to be contrasted with the outcome. Actually, the costs were enormous. At the end the net loss amounted to DM 275 billion (Deutsche Bundesbank (1994)). The deficit is mostly attributable to the old socialist system which left the companies in a poor condition. The question cannot be answered here if the deficit might have been smaller using a different approach to privatization (Brücker (1995)).

TABLE 6.2.2

Selected economic support measures for eastern German companies, 1991-1996
(Billion deutsche marks)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*
Tax concessions						
Investment allowances	1.04	4.19	4.89	4.44	3.64	2.49
Depreciation allowances	3.40	4.90	6.30	7.10	9.10	9.50
Financial support						
Investment grants	7.52	6.39	6.98	6.70	5.08	6.27
Soft loan programmes:						
ERP loans	8.15	6.12	6.80	6.02	4.10	3.58
Kreditanstalt für Wiederaufbau	5.92	6.34	3.96	3.79	2.05	2.14
Deutsche Ausgleichsbank	3.52	3.88	3.49	3.14	2.47	2.47

Source: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Wachstum, Beschäftigung, Währungsunion – Orientierungen für die Zukunft. Jahresgutachten 1997/98* (Stuttgart, Metzler-Poeschel), (1997).

A system of different programmes for financial assistance was installed as the second pillar of economic policy for supporting eastern German companies to become competitive. Investment in eastern Germany mostly did not seem to be very attractive, especially immediately after unification, as a whole range of obstacles had to be taken into account: transport and communications infrastructures were in a poor state, there were uncertainties related to the clearance of restitution claims and public administration was inefficient. This also applied to those companies which expected potential locational advantages or interesting market potential. Consequently, a wide range of instruments for the promotion of companies was introduced.

Although there is a huge number of programmes, economic support for companies in eastern Germany is mainly concentrated on supporting investment activities. The few programmes which are most important to firms offer bonuses for investment: investment grants available within the framework of the joint central-state government programme "Improving regional economic structure" (*Gemeinschaftsaufgabe*); tax-free investment allowances; special depreciation allowances; soft loan programmes implemented by the European Recovery Programme (ERP); and other soft loan programmes for new companies. The incentives are very high: for example the investment grant subsidizes 35 to 50 per cent of the invested amount; investment allowances, 8 to 12 per cent.

It is not easy to calculate the total amount spent on subsidization. Taking tax concessions, investment grants and soft loan programmes into account the support for companies of all branches amounted to DM 26 billion in 1996 (table 6.2.2). According to the estimations of the DIW the amount is even higher. This calculation includes financial support, tax concessions, transfers from the Federal Labour Office and the ERP subsidies. In addition, support by the THA was estimated, which to a great extent includes hidden wage cost subsidies (Stille and Teichmann (1997)). In 1996 the amount of about DM 65 billion was spent on the subsidization of companies. Since unification the sum has reached about DM 394 billion. The actual amount is even higher as subsidies granted by the *Bundesländer* and the local authorities are not included in these figures. The proportion of subsidies related to investment increased from one year to the next and reached about 60 per cent of all firm-related subsidies in eastern Germany in 1996. In relation to investment by firms, though, investment support accounts for about one quarter of investment. In contrast, the western German figure, at around 4 per cent, is very low. About DM 100 billion – one quarter – of the money flowed into manufacturing. It is scarcely conceivable that investment growth in eastern Germany would have been so marked if the intensity of support had not remained virtually constantly high.

6.3 Enterprise restructuring: some considerations

The main issue in catching up the western German economy is to extend and broaden manufacturing activities in the eastern region. In principle, there are different ways to achieve this which do not exclude each other and which can also be taken together: either production capacities and employment are shifted from western Germany or abroad to eastern Germany, or existing local and newly founded firms are able to strengthen their competitiveness and grow.

In principle, economic restructuring concerns the way companies try to gain competitive advantage. Attaining competitiveness simply means that firms are able to convince the customers and that they can sell their products. There are several preconditions: companies should be able to realize market opportunities, to develop products according to market needs, to produce them at favourable costs and, last but not least, to establish an efficient sales and distribution system for keeping their current customers and attracting new ones. Attaining competitiveness also means not only reacting to market changes, but also recognizing and influencing future market trends. First, firms have to decide on their "competitive scope" (Porter (1990)), concerning choosing the range of products, the type of buyers, the geographic areas, etc. Principally, competitive advantage may be reached either by product specialization and differentiation (for example, on new and high quality products) or cost leadership (for example, for existing products by innovative low-cost production and distribution systems). Of course, product specialization and cost leadership can be attained at the same time.

This paper examines how far the reconstruction process has succeeded in eastern German manufacturing, taking into account the role of economic policy and the fast and enormous change-over in the number of firms and the ownership structure of the companies' stock. On the one hand, former state owned companies were privatized, reprivatized or closed down, on the other hand, new firms were founded. The investors came from eastern Germany itself, from western Germany or from abroad. Not only are big international companies involved in eastern Germany, but also the so-called "*Mittelstand*", i.e. medium-sized companies which are not affiliated to big conglomerates, as well as individuals who may have started a company for the first time. In addition, there are still some privatized companies where the successor institutions of the Treuhandanstalt are partly involved.

It is quite clear that an examination of the competitiveness of eastern German manufacturing industry has to take into account its heterogeneous structure. It can be assumed that reconstruction strategies and competitiveness differ very significantly for different types of firms. In general, it is assumed that privatized firms perform much better than government owned companies and that they are able to acquire more efficiently the essential requirements of competitiveness, such as market know-how, investment capital and management skills. However, privatization is not a condition for a successful restructuring per se; it also depends on the specific implementation of privatization and on the competitive "competence" of the investor (Carlin, van Reenen and Wolfe (1994)). Therefore, closer investigation of the post-privatization process is needed. It is hypothesized that owners with market experience would be an advantage for eastern German plants as they may offer access to national and international markets. Thus, specific interest is attached to eastern German plants which are owned by western German or foreign companies in contrast to those which are non-affiliated companies.

6.4 Database

The investigation of the adjustment process in eastern German manufacturing is a very complex task requiring an appropriate, wide ranging database. It is obvious that information needs to be available on a firm level in order to compile data according to the different types of firms as described above. In this paper two sources of information are used: official data compiled by the German Central Statistical Office, and results from a questionnaire.

The German Central Statistical Office collects data on a firm level on production, turnover, exports, employment, wages and investment but due to strict data protection legislation, information is aggregated and available only on a sectoral or a firm-size level. This allows an analysis on the basis of average figures, but by this method, information on the complex adjustment process in eastern German manufacturing is limited. In this paper investigations of production and sectoral change, foreign market penetration and productivity and cost on average are based on these data.

Further important information for assessing the reconstruction process is not collected by the statistical office, for example, ownership status, competition problems, etc. More important, the individual adjustment process and the typical problems of expanding and shrinking companies, as well as the formation and closing of companies, cannot be analysed. In order to close this information gap, the DIW established its own database on eastern German firms. The DIW started at an early stage, commissioned by the Federal Ministry of Economics and with the collaboration of the Kiel Institute of World Economics (IfW) and the Institute for Economic Research Halle (IWH). So far, the DIW has conducted five surveys: summer 1991 (DIW and IfW (1991)); summer 1992 (DIW and IfW (1992)); winter 1993/94 (DIW, IfW and IWH (1994)); spring 1995 (DIW, IfW and IWH (1995)); and autumn 1996 (Brenke and Eickelpasch (1997)). The information was collected by a questionnaire sent out by mail. About 1,700 industrial firms employing more than 1 million workers participated in the summer 1991 survey; almost 2,000 industrial firms with about half a million employees responded in summer 1992; almost 2,500 firms with more than 200,000 employees were the respondents of the survey in winter 1993/94; 2,800 firms with 180,000 workers – in spring 1995; and more than 3,800 firms with 250,000 employees – in autumn 1996.

Comparisons with official data are very difficult as the official survey programme differs from that chosen in the DIW surveys in various ways. In particular, the DIW surveys also cover small-scale industry. This sector of manufacturing industry is much more developed in eastern Germany than in western Germany. Official data only take into account companies with 20 and more employees. However, it can be assumed that the DIW sample gives a representative picture of the situation in eastern German manufacturing industry.

The questionnaire consists of different parts. Some questions deal with the actual situation as assessed by an individual firm, others cover such "hard facts" as turnover, market areas, employment, investment and ownership status. These questions were repeated in all the surveys so that investigation over a period of time is possible. In addition, some questions covering different issues were substituted from one survey to the next. For example, in autumn 1996, information on the evaluation of subsidies was collected as well as on negotiations of privatized companies with the successor institutions of the Treuhandanstalt. In this paper some of the information is presented. As a proxy for performance, a bundle of characteristics is used such as the assessment of companies with regard to their competitiveness, obstacles they are facing, capacity utilization and market structure, profit situation and, last but not least, investment behaviour.

Due to the design of the surveys, there are different ways of using the data. First, data on firms can be analysed for each survey separately. Comparison of results provides information on the process of adjustment at an aggregate level. Second, the surveys can be considered as a panel of those firms which contributed to all five inquiries or some of them and, thus, will allow a longitudinal analysis on adjustment processes of individual firms. However, due to the fact that since unification entries and exits have been very high, only a relatively small number of firms can be observed on a longitudinal approach. In this paper, panel analysis is presented for the last two surveys.

6.5 Enterprise restructuring: results on an aggregate level

(i) Sectoral specialization

When, on 1 July 1990, the GEMSU between the two German states came into force, it was already apparent that the industrial sector of the German Democratic Republic (GDR) would be unable to withstand the competitive pressure from the west for long. The big conglomerates, controlled by the government, hierarchically structured and bureaucratic, entered the market system with low competitiveness due to an obsolete capital stock and overmanning, insufficient product quality, distorted specialization and an orientation towards the former CMEA, as well as deficient management capacities and, as a result, low productivity. In addition, the continuing revaluation of the GDR mark against the deutsche mark from 1:4 to 1:2 in the first half of 1990 and finally to an exchange rate of 1:1, combined with drastically increasing wages, weakened their position significantly. Producers lost their former markets: the few orders coming from the west failed to appear, and traditional partners in the former CMEA, the most important trading partners, did not want to import eastern German products any longer. Initially, however, only a small number of plants were closed. The majority remained in operation for the time being, although in most cases at a greatly reduced rate of capacity utilization. Their continued use was only possible because of massive financial support by the government. The THA covered eastern German companies' liquidity requirements generously by standing guarantees for them. In addition, substantial government support bolstered exports to eastern Europe.

As a result, in the second half of 1990 gross value added was only half the level recorded during the first half of the year, and at the beginning of 1991 it was only one third of the level prior to unification. During 1991 and 1992 output continued to decline slightly. Since the start of 1993, however, output has been expanding and the pace of expansion has been increasing. It is remarkable that the strong dynamic growth has persisted. In 1997 the rates of output growth on the previous year increased steadily; in the third quarter, value added was 15 per cent higher than a year earlier (chart 6.5.1).

The output recovery was initially confined to those goods destined primarily for the domestic market in eastern Germany and for which proximity to the sales market was a significant locational advantage. Quarrying, for example, experienced strong output growth, and the recovery began comparatively early in steel construction, metal goods, the printing industry, plastics processing and some sections of the food industry. Other industries, such as paper and cardboard production and automobiles, followed soon after. Output has also begun to rise in "problem industries" such as iron and steel and chemicals.

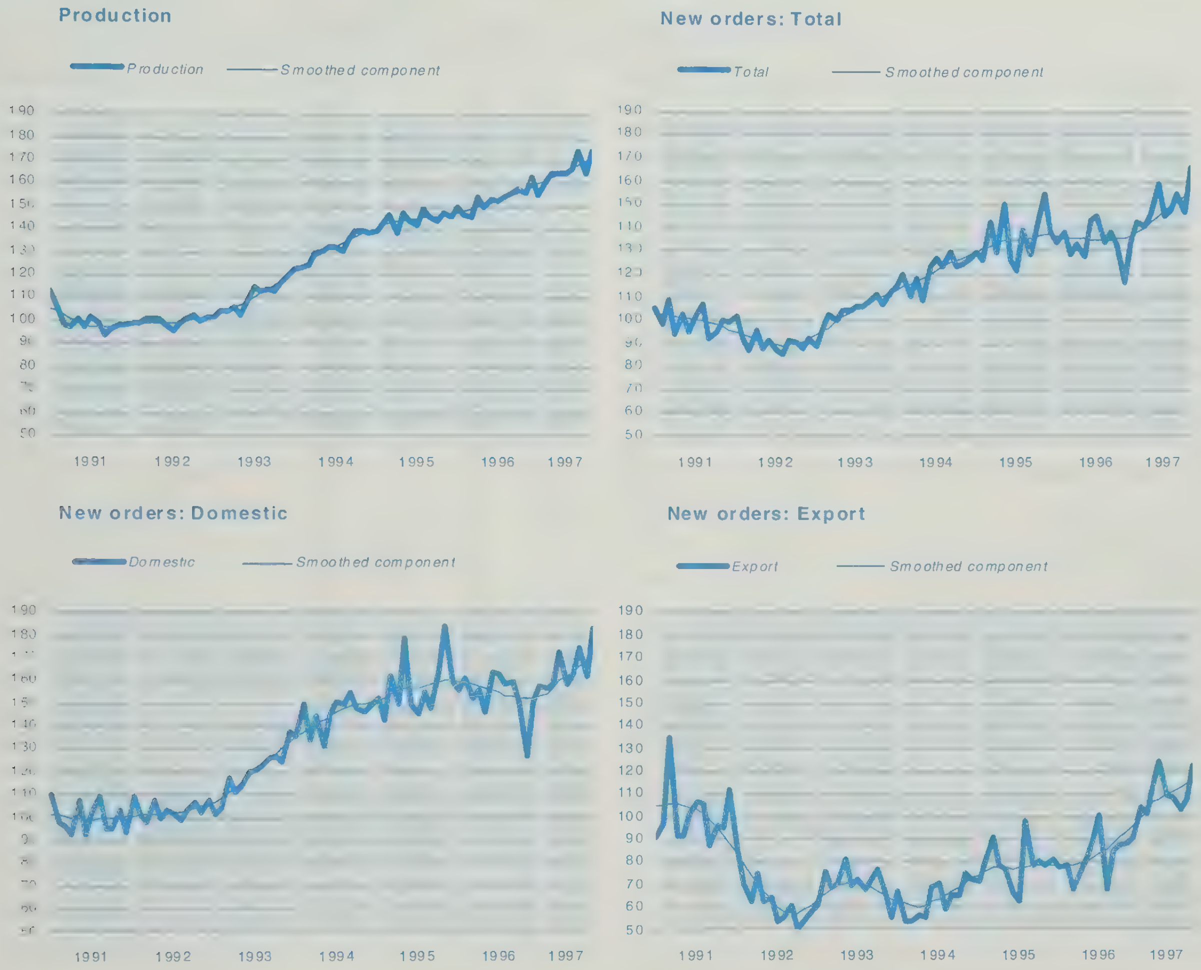
Some of the industries which recovered quite fast after unification have continued to expand, particularly those which have benefited from the building boom such as quarrying, but also food and plastics processing. Production is also expanding, however, among some of those industries which are oriented to supranational markets and which suffered from a downward trend in the first years after unification. The development in computers and office machinery is striking, production expanding very strongly when the new plants commenced operating at the end of 1995. The same can be observed for chemical products, both for basic chemicals and other products such as detergents. In automobile assembly, production has not expanded further but in 1996 it was about three times as high as it was in 1991. It is notable that the industry which supplies components for the automobile industry is also expanding. A major problem for eastern German manufacturing is still the machinery industry, where production is stagnating, and shipbuilding, where production has even shrunk further. All in all, it can be seen that the pattern of development which was typical for the period immediately after unification has changed. In recent years the dynamic forces were not only those industries which are oriented to local markets. The investments of firms with supraregional orientation are reflected more and more in the expansion of production.

In only a few years eastern German manufacturing has experienced unprecedented structural change. The loss of relative importance of investment goods is striking. The machinery industry, once the showcase of GDR industries, contributed about 25 per cent to overall production before unification; in 1996 it was only about 9 per cent – much the same as quarrying. Electrical engineering, chemicals and shipbuilding have also lost their dominant role. Instead, eastern German manufacturing today is characterized by the predominance of food processing and quarrying (mineral products). In 1996, these branches added up to one third of overall production (table 6.5.1). The proportion of strongly expanding branches with a somewhat supranational orientation is still quite low. All in all, those industries which sell their products mainly in international markets have lost in importance, whereas those industries which produce mainly for home markets have gained. It seems that eastern German

CHART 6.5.1

Production[a] and the volume of new orders in east German manufacturing industry, January 1991 to September 1997

(Indices, 1991=100)



Source: Federal Statistical Office, DIW.

Note: Data are seasonally adjusted.

[a] Adjusted for variations in the number of working days.

manufacturing has become more and more oriented to those markets where competitiveness and integration into international markets is comparatively low. How far this process has proceeded can be seen when branches are grouped according to their intensity in international trading. The proportion of branches with non-tradable goods, i.e. goods with trade intensity below average, grew from 35 per cent (1990) to 60 per cent (1993) and the proportion of those with tradable goods declined from 65 per cent to 40 per cent (Klodt (1994)).

Nevertheless, structural change has not come to an end, but is ongoing, and as the expansion of goods with supranational orientation shows, it will change its direction. It is to be expected that the sectoral structure in eastern Germany will more or less have to follow that of western German manufacturing (which itself will change over time) as it is assumed that in the long run there is not very much room for eastern German manufacturing to play a complementary role to western German manufacturing. Thus, a second "wave" of sectoral adjustment, following the first "wave" due to transformation, can be assumed, characterized by the need for further integration into an open economy.

(ii) Exports

The notable orientation of eastern German manufacturing on domestic markets can also be seen from the fact that from 1991 to 1996 domestic turnover expanded more strongly than foreign sales. By 1991, foreign sales as a proportion of total turnover was around 16 per cent and it declined to around 13 per cent in 1996 (table 6.5.2). Western German manufacturing, by

TABLE 6.5.1

Gross production in manufacturing, 1991 and 1996
(Per cent)

	Structure				*Growth rate per annum*	
	1991		*1996*		*1991 to 1996*	
	East Germany	*West Germany*	*East Germany*	*West Germany*	*East Germany*	*West Germany*
Beverages and food	18.0	9.7	21.2	10.7	11.5	0.5
Tobacco products	2.3	1.7	1.7	1.5	2.4	-3.8
Textiles	2.1	2.0	1.8	1.4	6.6	-8.0
Clothing	1.1	1.9	0.4	1.1	-8.2	-11.8
Leather	0.6	0.6	0.2	0.4	-15.0	-10.7
Wood	1.1	1.4	1.9	1.5	23.5	0.4
Pulp and paper	1.6	2.6	2.5	2.7	20.8	-0.9
Printing [a]	0.9	1.8	0.8	1.7	6.6	-2.3
Refinery and coke oven products	4.9	5.2	4.3	5.8	5.6	0.2
Chemical products	11.0	9.7	7.6	11.2	1.7	1.7
Plastics and rubber products	2.3	4.4	4.0	4.2	19.8	-1.8
Glass, pottery and mineral products	4.6	3.1	9.2	3.2	23.1	-1.0
Metals	6.5	5.2	5.2	4.8	4.3	-2.3
Metal products	3.9	5.7	7.7	6.1	22.5	0.1
Machinery	17.4	13.8	9.2	12.8	-2.7	-2.9
Computers and office machinery	0.5	1.8	1.2	1.6	24.0	-2.2
Electrical engineering	6.1	6.1	5.7	6.2	7.7	-1.2
Media technology products	1.4	2.1	1.2	2.0	8.6	-1.3
Precision instruments	2.0	2.5	2.1	2.5	11.4	-1.9
Road vehicles	2.3	14.0	6.2	14.3	29.0	-1.5
Other transport vehicles	6.6	1.9	3.1	1.5	-7.7	-6.6
Furniture and toys	2.8	2.9	2.8	2.7	9.3	-3.2
Manufacturing [a b]	100.0	100.0	100.0	100.0	9.2	-1.4
Intermediate goods [b c]	56.3	45.7	51.2	47.5	7.7	-0.6
Investment goods	30.3	33.2	25.8	32.2	6.5	-2.2
Consumer durables	4.6	5.2	3.5	4.4	3.1	-4.5
Consumable goods [a]	24.3	17.9	24.7	17.5	8.6	-1.8

Source: Deutsches Institut für Wirtschaftsforschung (DIW).

[a] Without publishing.

[b] Without recycling.

[c] With mining and quarrying.

contrast, exported an average of 32 per cent of its output in 1996. The low export activities certainly cannot be explained by a sectoral structure different from that of western Germany. In fact, all of the branches in eastern German manufacturing show less exports than the corresponding branches in the west. The regional structure of exports has also changed dramatically, sales to eastern Europe losing importance significantly but sales to western Europe becoming more and more important. Eastern German manufacturing's contribution to the exports of German manufacturing as a whole is very low: in 1996, 2.5 per cent of overall foreign sales came from eastern Germany, whereas it contributed 6 per cent to overall production in German manufacturing.

(iii) Productivity and unit labour costs

The continuous expansion of production is only one way to show that the adjustment process in eastern German manufacturing has progressed very well. This can also be illustrated by the development of productivity and unit labour costs. Initially, there was a sharp rise in productivity. At the end of 1992 output per working hour was already as high as at the start of 1991, rising to more than three times as high by the end of 1997. In view of the initial stagnation of output, such productivity growth was achieved by massive cuts in the volume of working hours. More recently, however, against the background of rapid output growth, productivity has been increasing largely as a result of modernization measures. Even so, the productivity of eastern German industry, on average, remains significantly lower than in western Germany; just about two thirds of the western German level had been reached by 1997.

In spite of the difficult economic situation, the wages of industrial workers rose faster than productivity. Not until mid-1992 did the situation change; since then, unit labour costs have been falling despite rapid wage growth. The gap in terms of costs has not yet narrowed, however. In 1997 average unit labour costs were still one quarter above those in western German manufacturing.

TABLE 6.5.2

Exports in manufacturing, 1991 and 1996

(Per cent of total turnover)

	1991		*1996*	
	East Germany	*West* Germany	*East* Germany	*West* Germany
Beverages and food	4.1	8.4	6.2	10.9
Tobacco products	1.6	7.0	4.5	12.6
Textiles	14.2	25.1	19.0	28.8
Clothing	7.4	20.7	10.3	23.7
Leather	13.7	20.6	10.3	23.2
Wood	3.0	9.5	10.1	9.1
Pulp and paper	23.1	25.9	30.3	30.6
Printing [a]	3.6	7.0	3.1	7.2
Refinery and coke oven products	5.6	2.9	2.3	2.7
Chemical products	25.5	41.1	24.5	44.2
Plastics and rubber products	15.1	21.7	8.8	25.6
Glass, pottery and mineral products	8.2	16.2	4.1	16.6
Metals	20.0	29.6	25.3	35.7
Metal products	2.7	16.7	4.5	19.7
Machinery	27.9	40.0	21.1	45.4
Computers and office machinery	24.2	43.4	26.2	36.6
Electrical engineering	8.6	27.1	10.5	35.4
Media technology products	26.8	32.1	26.6	39.1
Precision instruments	8.7	29.8	24.1	39.3
Road vehicles	15.7	43.1	15.2	50.9
Other transport vehicles	49.6	48.0	21.1	43.0
Furniture and toys	14.3	18.9	9.0	17.6
Manufacturing [a b]	15.8	27.8	12.8	31.6
Intermediate goods [b c]	11.8	24.4	12.9	27.6
Investment goods	24.6	39.4	15.8	45.5
Consumer durables	13.5	25.1	15.4	24.8
Consumable goods [a]	6.9	13.8	7.3	16.6

Source: Deutsches Institut für Wirtschaftsforschung (DIW).

[a] Without publishing.

[b] Without recycling.

[c] With mining and quarrying.

6.6 Enterprise restructuring: evidence from the DIW enterprise panel

(i) Ownership change

At the beginning of the GEMSU, manufacturing in the German Democratic Republic was nearly completely state owned and consisted of very few, very large units with a lot of plants. The whole of manufacturing was concentrated in 221 so-called "*Kombinate*", i.e. horizontally or vertically integrated conglomerates of plants (Staatliche Zentralverwaltung für Statistik (1989)). Of these, 126 *Kombinate* were directly controlled by the ministry which was responsible for the corresponding industrial branch. They consisted of 40 to 60 plants and employed on average 10,000 to 20,000 workers, some up to 60,000 workers. The remaining 95 *Kombinate* were controlled by local authorities and they were smaller, about 5,000 employees on average.

After reunification, ownership change took place in two different ways: on the one hand, by privatizing the former state owned companies, on the other hand, by founding new firms.

It was the THA's task to privatize rapidly the companies of which it had taken charge. At the beginning, the THA could not find an investor for most of the companies, as they were mostly too large, their production programmes were too diversified, or the capital stock was worn out. Thus, the THA pursued a strategy of splitting up the former *Kombinate* into smaller units (Schmidt (1993)). This strategy of "decomposition", taken together with the massive quasi-subsidization mostly via favourable prices for the investors, led to fast and substantial changes in ownership. By the end of 1994, the THA had sold most of its firms and hence the institution was closed. In addition to this "top-down" privatization, new companies started business. Often referred to as "bottom-up" privatization, they formed the second part of ownership transformation.

In summer 1991, 86 per cent of eastern German manufacturing companies, with 92 per cent of total employees, were owned by the THA. Over time, the ownership structure changed rapidly. As early as spring 1995, the privatization process had more or less come to an end. In 1996, there was just a handful of former industrial combinations (1 and 5 per cent, respectively) which were not yet in private ownership but administered by one of the successor institutions of the Treuhandanstalt (table 6.6.1). Of those companies which were previously state owned, most were privatized and comparatively few were reprivatized. This may be explained by the specific legislative rules for the treatment of privately owned firms which had been nationalized in the GDR. The government was interested in quick restructuring and gave priority to the former owner if he agreed to make the same investments as another potential investor. Thus, some of the former owners who did not want to engage in this process dispensed with reprivatization.

As the second pillar of privatization, new firm formation became more and more important. In 1992, roughly one tenth of all companies were newly established, whereas in 1996, start-ups accounted for 44 per cent of manufacturing. Clearly, start-ups are normally small- and medium-sized companies and, consequently, they account for about one fifth of the manufacturing workforce.

In autumn 1996, more than three quarters of the firms surveyed could be considered as "independent" enterprises not affiliated to western German firms or to companies from abroad. Most of them were small- and medium-sized firms. On the other hand, one fifth of the enterprises were subsidiaries, yet they accounted for one half of the jobs in manufacturing. Between 1995 and 1996 there was little change in respect of ownership status.

TABLE 6.6.1

Eastern German manufacturing firms according to ownership status, 1991-1996
(Per cent of all firms and employees)

	Summer 1991		*Summer 1992*		*Winter 1993/94*		*Spring 1995*		*Autumn 1996*	
	Firms	*Employees*	*Firms*	*Employees*	*Firms*	*Employees*	*Firms*	*Employees*	*Firms*	*Employees*
Private firms	14	8	66	41	94	76	99	95	99	95
of which:										
Independent firms	9	1	49	19	80	42	77	50	77	51
Firms owned by west German or foreign firms	5	7	17	23	14	34	22	45	22	44
of which:										
Privatized Treuhand firms	–	–	48[a]	36[a]	41	55	34	60	33	57
Reprivatized Treuhand firms	–	–	–	–	20	8	17	13	13	10
Private firms before 1990	–	–	5	2	7	5	5	2	8	6
Firms founded after 1989	–	–	13	3	26	7	43	20	44	22
Firms owned by the Treuhand or its successor organizations	86	92	34	59	6	24	1	5	1	5
All firms	100	100	100	100	100	100	100	100	100	100

Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94, spring 1995 and autumn 1996.

[a] Including reprivatized firms.

(ii) Overall performance of enterprises and obstacles

The comparison of the five sets of annual results shows that the firms initially perceived themselves to be facing massive problems, but that the pressure to adjust to these problems has since been steadily declining. In summer 1991, more than four fifths of the firms reported that they were experiencing great difficulties in holding their own in the market. In summer 1992, the figure was mo[illegible]an two thirds and in spring 1995, it only slightly exc[illegible]d one half. Since then, however, the situation has not improved further, the share of companies with major competitive problems remaining relatively stable (table 6.6.2).

The gravity of the competitiveness problem varies for different enterprise categories:

- It is particularly acute for the firms owned by the Treuhandanstalt or its successor institutions. In 1991, almost all Treuhand firms, according to their own evaluation, faced massive problems, but subsequently the relative share of these problematic firms declined sharply as Treuhand firms were privatized or closed down. During the last survey year (1996) the situation of the remaining firms had become more serious again. It seems that the longer companies are taken care of, the more they are unable to solve their problems.
- Among privatized and reprivatized firms, too, the proportion of companies facing major problems was considerable, although they were better off than Treuhand companies. However, it seems that the adjustment process, which made progress in the first years after unification, has come to an end as the share of companies facing major problems in 1996 has grown compared with 1995.

TABLE 6.6.2

Eastern German manufacturing firms facing problems in the market, 1991-1996
(Per cent of all firms surveyed)

	Summer 1991	*Summer 1992*	*Winter 1993/94*	*Spring 1995*	*Autumn 1996*
Private firms	62	57	55	52	55
of which:					
Independent firms	73	59	55	55	56
Firms owned by west German or foreign firms	56	52	56	45	50
of which:					
Privatized Treuhand firms	–	62[a]	60	55	61
Reprivatized Treuhand firms	–	–	64	65	61
Private firms before 1990	–	58	51	48	51
Firms founded after 1989	–	41	45	46	50
Firms owned by the Treuhand or its successor organizations	88	84	82	53	89
Firm size by employees					
1 to 19	75	61	51	52	54
20 to 49	81	63	55	54	55
50 to 99	78	67	63	54	54
100 to 199	84	65	65	47	62
200 to 499	85	73	63	48	54
500 and more	92	78	77	58	59
All firms	85	66	57	52	55

Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94, spring 1995 and autumn 1996.

[a] Including reprivatized firms.

- According to the survey findings, new businesses have definitely experienced fewer difficulties in withstanding competitive pressures. Clearly, these firms started without the burdens of a socialist economy. Start-ups and reprivatized firms are mostly small and thus have often been able to find a small market niche. Nevertheless, the situation for these companies has also not improved over time. The contrary is true: in 1992 only two fifths of the surveyed start-ups were complaining of the competitive pressures, but this proportion increased from one survey to the next, and in 1996 they accounted for half of the surveyed firms.

- As far as ownership status is concerned, it is evident that independent firms are more likely to face problems than those owned by western German and foreign companies. However, the difference between the two categories is not as high as expected. This may be due to the fact that the THA also sold to western investors those companies which were operating in "sensitive" branches, most of which were suffering from worldwide overcapacity. Obviously, some investors underestimated the massive problems of restructuring, while others who bought a company in order to get access to the eastern European markets were not able to realize their intentions.

Some problems have proved particularly thorny throughout the entire period. More than half of the companies reported that they were facing rising competitive pressure, severe problems of financing, rapid wage growth and high labour costs (table 6.6.3). In addition, it seems that some local conditions have not improved substantially. In 1996 the proportion of companies reporting that it was difficult to find skilled labour or that local administration was sluggish had grown against 1995. On the other hand, some of the in-house problems obviously have been solved. The proportion of firms operating with outdated machinery and those reporting problems on the sales/distribution side has declined. Overall, these trends suggest that the problems of adjusting to the market economy have largely been overcome. But those problems which are typical for the consolidation of firms and for market penetration are becoming more relevant.

TABLE 6.6.3

Selected problems perceived by manufacturing firms in eastern Germany, 1991-1996

(Per cent of all firms)

	Summer 1991	*Summer 1992*	*Winter 1993/94*	*Spring 1995*	*Autumn 1996*
Social security contribution growth too rapid	–	–	–	–	62
Wage costs too high	–	–	–	–	60
Delays in recouping debt	–	–	–	59	56
Inadequate equity capital	–	–	–	52	51
Increasing competitive pressure	–	–	–	50	56
Liquidity constraint	–	–	–	49	47
Wage and salary growth too rapid	31	44	41	43	39
Lack of finance for investment	53	49	39	43	39
Difficulty in obtaining skilled labour	6	17	20	27	27
Suppliers of comparable products cheaper	–	22	26	26	32
Local administration clumsy	–	28	25	26	32
Plant/buildings outdated	38	38	28	23	18
Sales/distribution inadequate	46	39	18	22	22
Local infrastructure inadequate	15	28	18	17	20
Shortage of commercial sites and premises	–	13	14	16	12
Skill level of workforce inadequate	14	13	10	9	–
After sales service inadequate	–	13	10	6	9
Product quality inadequate	7	7	4	2	–
Plant/equipment too large	16	16	10	–	–
Key staff have left the firm	6	7	3	–	–

Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94, spring 1995 and autumn 1996.

In order to determine whether firms have been able to solve their problems, or whether they are now facing new difficulties, it is not sufficient merely to compare a number of unrelated cross-sectional analyses. What is required is a longitudinal analysis of individual firms. For that reason, the survey in spring 1995 was combined with the survey in autumn 1996. To this end, the 1,200 firms that participated in both surveys were selected. These firms account for around two fifths of the firms surveyed in spring 1995 and for one third of those having participated in the autumn 1996 survey.

The results of this longitudinal evaluation of the data confirm the picture already given: in 1995 just half of the firms believed that they could withstand competitive pressure without great difficulty, while the remainder were clearly facing major problems (table 6.6.4). This distribution has changed slightly over time. In 1996, 59 per cent of the firms evaluated their situation as critical. More detailed analysis reveals more strongly differentiated trends, however:

- Only one fifth of the firms experiencing significant competitiveness problems in spring 1995 have since then managed to overcome these initial difficulties. To put it another way, 79 per cent of the firms experiencing problems at that time have not made decisive progress.
- For as many as 37 per cent of the firms which, by and large, were operating without serious problems in spring 1995, the situation has become worse: in autumn 1996 they were suffering serious competitiveness problems.

The adjustment process in the period between spring 1995 and autumn 1996 has been slightly sluggish among privatized firms and companies that were privately owned prior to unification. Compared with the average of manufacturing, many of the firms founded after 1989, on the other hand, have mastered their problems. At the same time, the share of privatized firms whose problems have worsened between 1995 and 1996 is also slightly disproportionately high and the share is significantly high concerning those firms privately owned before 1990. On the other hand, relatively few newly founded businesses reported a deterioration in their situation.

TABLE 6.6.4

Manufacturing firms in east Germany facing problems in the market, 1995 and 1996

(Per cent of all firms)[a]

	Firms experiencing problems in the market in 1995			*Firms not experiencing problems in the market in 1995*			*Memo item: firms facing problems in the market*	
		of which: firms that in 1996			*of which: firms that in 1996*			
	Total	*Still had problems in the market*	*No longer had problems in the market*	*Total*	*Still did not have problems in the market*	*Had problems in the market*	*1995*	*1996*
Private firms	100	78	22	100	63	37	51	59
of which:								
Privatized Treuhand firms	100	82	18	100	60	40	53	62
Reprivatized Treuhand firms	100	79	21	100	64	36	61	63
Private firms before 1990	100	82	18	100	50	50	47	65
Firms founded after 1989	100	72	28	100	67	33	45	51
of which:								
Independent firms	100	78	22	100	64	36	54	59
Firms owned by west German or foreign firms	100	82	18	100	61	39	41	56
Firm size by employees								
1 to 9	100	77	23	100	62	38	59	60
10 to 19	100	75	25	100	54	46	47	60
20 to 49	100	79	21	100	69	31	52	57
50 to 99	100	78	22	100	67	33	55	58
100 to 199	100	91	9	100	60	40	45	63
200 to 499	100	72	28	100	60	40	41	54
500 and more	100	81	19	100	50	50	59	70
All firms	100	79	21	100	63	37	51	59

Source: DIW surveys conducted in spring 1995 and autumn 1996.

[a] Firms that took part in both surveys.

TABLE 6.6.5

Selected problems for manufacturing firms in east Germany, 1995 and 1996

(Per cent of all firms)[a]

	Firms experiencing the problem in 1995				*Firms not experiencing the problem in 1995*				*Memo item: firms that had the problem in 1996 (per cent of all firms)*
		of which: firms that in 1996				*of which: firms that in 1996*			
	Total	*Still had the problem*	*No longer had the problem*	*Memo item: firms as a per cent of all firms*	*Total*	*Still did not have the problem*	*Had the problem*	*Memo item: firms as a per cent of all firms*	
Competition rising	100	76	24	51	100	62	38	49	58
Customer in arrears	100	75	25	57	100	71	29	43	55
Lack of own capital stock	100	78	22	51	100	76	24	49	52
Liquidity shortage	100	70	30	48	100	72	28	52	48
Wages and salaries growth too rapid	100	62	38	47	100	67	33	53	40
Lack of finance for investment	100	61	39	41	100	77	23	59	38
Plant/buildings outdated	100	49	51	23	100	90	10	77	19
Sales/distribution inadequate	100	46	54	21	100	88	12	79	19
Suppliers of comparable products cheaper	100	58	42	27	100	78	22	73	32
Local administration clumsy	100	58	42	22	100	84	16	78	25
Difficulty in obtaining skilled labour	100	49	51	28	100	88	12	72	23
Local infrastructure inadequate	100	50	50	17	100	88	12	83	18
Shortage of commercial sites and premises	100	32	68	15	100	93	7	85	10
After sales service inadequate	100	35	65	5	100	94	6	95	7
Work flow management in plant not yet optimal	100	38	62	16	100	62	38	84	15

Source: DIW surveys conducted in spring 1995 and autumn 1996.

[a] Firms that took part in both surveys.

The situation of many independent firms has grown more acute in recent years. Fewer of them have proved able to overcome the initial problems. It seems that the firms owned by the western German or foreign companies were better in coping with the adjustment process, though the difference is slight.

Concerning the kind of problems companies are facing, the longitudinal analysis confirms the results from the cross-sectional analysis. The typical problem areas are rising competition, difficulties in obtaining finance and wage trends (table 6.6.5). Remarkably, only about one fifth to one third of the firms surveyed had mastered these problems between 1995 and 1996. In addition, about one quarter of the firms who had not had those problems in 1995, faced them subsequently.

All in all, the longitudinal analysis of the adjustment process shows that the individual situation of companies has changed over time: many have improved while many others experienced a change for the worse. It seems that there is no clear pattern when ownership status is taken into account. All types of companies, privatized as well as those newly founded, and independent ones as well as those owned by western German or foreign companies, can face serious competitive problems.

(iii) Capacity utilization, incoming orders and market access

More information about the very diverse situation in eastern German manufacturing can be drawn from results of the survey concerning capacity utilization and incoming orders. Around 70 per cent of the firms surveyed reported that their capacity utilization was “rather good” or “satisfactory”. About 80 per cent of firms expressed the same view on the state of their order books (table 6.6.6). Even so, there remains a significant number of firms in which capacity utilization and incoming orders are unsatisfactory. Such firms are to be found in large numbers in every branch and every size category, in independent firms and in western German and foreign owned subsidiaries, among the former Treuhand firms and among companies set up after monetary union. Nevertheless, the proportion of firms experiencing these problems is relatively high for Treuhand companies, and also quite high among reprivatized companies. In the latter case it could be that some proprietors overestimated their capabilities for running a business when they took back ownership. In general, firms experiencing difficulties in maintaining their market position are to be found throughout eastern German industry. At the same time, there are branches in which such firms are particularly common, indicating that the problems are to be found at both the enterprise and branch level.

The most important sales market for eastern German industry remains the new federal states themselves. Almost 44 per cent of total turnover was realized there in 1996, yet 15 per cent of total turnover was with customers in the immediate vicinity (table 6.6.7). West Germany accounts for a third of sales. At 5 per cent, eastern Europe now plays only a subordinate role as a sales market, and sales to western countries make up a similarly small proportion of turnover. Since 1995, there has been a quite stable situation in regional sales structure in favour of the western German market.

TABLE 6.6.6

Capacity utilization and incoming orders in eastern German manufacturing firms, 1996

(Per cent)

	Per cent of firms evaluating capacity utilization as			*Per cent of firms evaluating incoming orders as*		
	Rather good	*Satis-factory*	*Rather bad*	*Rather good*	*Satis-factory*	*Rather bad*
Private firms	22	47	31	23	51	26
of which:						
Independent firms	22	48	30	23	51	26
Firms owned by west German or foreign firms	23	45	32	24	49	27
of which:						
Privatized Treuhand firms	23	53	24	28	51	21
Reprivatized Treuhand firms	15	46	39	18	50	32
Private firms before 1990	21	46	33	20	51	29
Firms founded after 1989	24	49	27	27	50	23
Firms owned by the Treuhand	16	40	44	–	61	39
Firm size by employees						
1 to 9	18	46	36	20	48	32
10 to 19	20	47	33	23	51	26
20 to 49	24	49	27	25	52	24
50 to 99	25	47	28	26	53	22
100 to 199	23	46	31	23	52	25
200 to 499	20	47	33	21	49	30
500 and more	27	45	28	30	45	25
All firms	22	47	31	23	51	26

Source: DIW survey conducted in autumn 1996.

At first sight, there is not much evidence for the hypothesis that western owned companies have better access to western markets than independent firms. For both categories of firms the market share for the immediate vicinity and the rest of eastern Germany is a bit less than one half of turnover. Nevertheless, the export share of those firms is, on average, significantly higher than that of independent firms. The main reason for the unexpectedly high local orientation of western firms is that some companies from the west or abroad came to eastern Germany to serve mostly local markets, such as those for construction supply or food and beverages. Privatized firms seem to be more successful in western markets, quite independently of the ownership structure. On the other hand, start-ups are more oriented to local markets.

In 1997, eastern German industry is expected to increase turnover by around 8 per cent compared with the previous year. This is a higher rate of growth than that achieved between 1995 and 1996. Expectations are particularly optimistic with respect to foreign markets:

TABLE 6.6.7

Distribution of turnover of eastern German manufacturing firms, 1996
(Per cent)

	Per cent of total turnover distributed to markets:					
	In immediate vicinity[a]	*Somewhere else in east Germany*	*Somewhere else in west Germany*	*In eastern Europe*	*Somewhere else abroad*	*Total*
Private firms	16	28	35	5	16	100
of which:						
Independent firms	18	31	34	4	13	100
Firms owned by west German or foreign firms	15	26	35	6	19	100
of which:						100
Privatized Treuhand firms	12	27	36	6	19	100
Reprivatized Treuhand firms	18	28	32	6	17	
Private firms before 1990	30	29	30	2	10	100
Firms founded after 1989	25	32	33	2	9	100
Firms owned by the Treuhand	2	41	47	1	10	
Firm size by employees						100
1 to 9	46	25	23	2	5	100
10 to 19	33	29	31	2	6	100
20 to 49	29	32	31	2	6	100
50 to 99	21	31	34	4	10	100
100 to 199	16	32	37	3	12	100
200 to 499	12	26	39	8	15	100
500 and more	8	27	37	5	24	100
All firms	15	29	36	5	16	100
Memorandum item:						
1995	16	30	35	5	14	100

Source: DIW survey conducted in autumn 1996.

[a] Radius of about 30 kilometres.

foreign sales growth of around one fifth is considered possible. Sales to western Germany should also expand perceptibly (12 per cent). Independent firms are very optimistic that they will expand, both in terms of overall performance and different market areas.

(iv) Investment strategies

In 1992, investment activities in eastern Germany increased very rapidly. Existing plants were modernized and new plants established. As there was no satisfactory information as to the scale of renewal of the eastern German capital stock, questions on investment activity and the size and modernity of capital stock have been included in the survey.

According to the results of the survey, investment activity remains high. Almost 90 per cent of manufacturing firms undertook investment in 1996, the same as in 1995. On the other hand, the 1996 investment volume decreased by a tenth compared with the previous year. Obviously, the peak of the investment cycle was reached in 1995. Investment levels were highest in quarrying, chemicals, food and the plastic products industries. Investment dynamics were somewhat less pronounced in the investment goods sector: mechanical and electrical engineering, steel and light metal construction and rail vehicles. Altogether, the branches mentioned accounted for almost two thirds of total industrial investment in 1996.

The investment volume per employee amounted to nearly DM 25,000 in 1996, although this average figure conceals major differences in the level of investment and in trends over time (table 6.6.8). Independent eastern German companies invested around DM 19,000 per employee in 1996, which amounts to merely two thirds of the sum committed on average by western German and foreign investors (DM 30,000). Compared with 1995, investment activity by the western German and foreign investors in the survey sample declined, whereas there was virtually no change among independent companies. Those companies that were being kept afloat by the successor institutions to the THA invested significantly more per employee than privately owned firms, although this is due to the fact that a small number of large investment projects exert a strong influence on the average figure.

Concerning the quality of the capital stock, a distinction should be made between machinery and buildings. According to the survey, one quarter of the firms were producing with totally or partly obsolete machinery, while three quarters of the firms evaluated their equipment as sufficiently modern or almost up-to-date. Concerning buildings, the situation had also improved: more than a half of the firms reported their buildings as being at a sufficient level. Quite clearly, the result of the high investment intensity of western German or foreign companies is documented in the figures. All in all, in 31 per cent of these plants, equipment had a higher

TABLE 6.6.8

Investment per employee in eastern German manufacturing industry, 1995-1996
(Deutsche marks)

	1995	*1996*
Private firms	25 500	24 100
of which:		
Independent firms	19 300	18 800
Firms owned by west German or foreign firms	32 800	29 800
of which:		
Privatized Treuhand firms	26 300	25 900
Reprivatized Treuhand firms	18 500	14 700
Private firms before 1990	28 500	19 300
Firms founded after 1989	25 700	24 900
Firms owned by the Treuhand	44 800	43 900
Firm size by employees		
1 to 9	19 000	26 400
10 to 19	20 700	26 200
20 to 49	20 200	18 300
50 to 99	17 700	16 600
100 to 199	23 300	22 100
200 to 499	25 000	23 900
500 and more	39 000	36 300
All firms	26 400	24 800

Source: DIW survey conducted in autumn 1996.

technical standard than in independent firms (19 per cent). About the same relationship can be found for buildings.

Companies have not only invested for reasons of modernization or replacement but also for expansion. Western owned companies have mostly reached their intended plant size already, most of them reporting that there was no need for further new machinery. On the other hand, among independent firms the share of such firms was also very high (70 per cent); nevertheless, one quarter of them were producing with insufficient equipment.

Any estimation of future investment activity is subject to great uncertainty, not least because at the time the survey was conducted a significant number of firms – four of each ten – were unable to commit themselves as to how much they would invest during 1997 (table 6.6.9). Concerning leasing, companies were also very irresolute. Those firms that had already taken a decision in this regard planned to cut their investment volume by almost 10 per cent compared with 1996. This figure is due primarily to the decline in investment by firms still under the control of one of the institutions that succeeded the THA. Privately owned companies, irrespective of their independent or subsidiary status, also intended to invest less in 1997 than they did in 1996.

However, the number of firms investing in order to expand capacity has fallen sharply. For large firms, in particular, the expansionary phase has, for the moment, been completed. According to the investment plans of the firms, in 1997 DM 24,000 per employee would be invested. Here, also, the western companies ranked higher than independent firms. All in all, the results of the survey suggested that the existing stock of companies could not be expected to achieve a further rise in investment during 1997.

(v) Profit situation and inadequate equity capital

Regarding the overall situation of the firms surveyed, it is not very surprising that most of the companies have not yet reached their break-even point; turnover is still too low to cover their costs. One third of the firms had significant losses in 1996 and another third just reached a balanced result (table 6.6.10). However, the differences between the categories of companies mentioned are very significant. First, and not very surprisingly, almost all firms still owned by the Treuhand successors were producing substantial losses. On the private side, there are differences as well. More than other firms, privatized and reprivatized companies seem to suffer from their historical burden. On the other hand, companies which already existed before unification seem to be better off, about half of them achieving profits, while newly founded companies obviously were also quite successful. Surprisingly, that does not correspond to the ownership structure. Western or foreign ownership does not always seem to be an advantage for eastern German firms. In this group, a smaller proportion of firms achieved reasonable, or at least low, profits.

Certainly, the fact that a company does not make profits does not necessarily lead to the conclusion that it is facing substantial problems. A number of firms invested a lot in recent years and this may be a reason for high depreciation and, hence, for low profits. This is especially true for companies owned by western German or foreign companies.

Nevertheless, since many companies are operating with losses it is not surprising that they are facing heavy financial constraints. As pointed out earlier, about half of the companies in the survey reported that they were facing inadequate equity capital. This is not surprising for firms which were founded only a few years ago. It is remarkable, however, that also half of the privatized companies reported that they were facing this problem. Normally companies offered for sale by the THA started well equipped for the market economy, as during the process of privatization they were supplied with equity capital by the THA and, in addition, were released from old debts. It was assumed this would ease the restructuring of companies. However, in many cases the obstacles obviously were underestimated and competitive pressure, as well as high labour costs, may have caused the decrease of the capital base.

As far as ownership status is concerned there are significant differences. In 1996, only 29 per cent of companies owned by western German or foreign companies complained about an inadequate equity base. In general, western companies have equipped their subsidiaries with sufficient equity capital. In contrast,

TABLE 6.6.9

Plans for investment and leasing of eastern German manufacturing firms for 1997

(Per cent of firms)

	Did not plan investments	*Planned investments*	*Investments not yet decided*	*Did not plan leasing*	*Planned leasing*	*Leasing not yet decided*
Private firms	9	52	39	50	15	35
of which:						
Independent firms	9	49	42	47	15	38
Firms owned by west German or foreign firms	7	63	30	58	14	28
of which:						
Privatized Treuhand firms	6	63	31	49	18	33
Reprivatized Treuhand firms	8	54	38	52	14	34
Private firms before 1990	14	41	45	49	13	38
Firms founded after 1989	10	47	43	50	13	37
Firms owned by the Treuhand	7	57	36	33	30	37
Firm size by employees						
1 to 9	12	34	54	50	8	42
10 to 19	10	46	44	50	12	38
20 to 49	10	50	40	48	15	37
50 to 99	5	45	30	51	17	32
100 to 199	4	73	23	52	22	26
200 to 499	1	86	13	46	29	25
500 and more	5	79	16	48	27	25
All firms	9	52	39	50	15	35
Memorandum item:						
1995	13	82	5	64	30	6
1996	15	85	–	68	32	–

Source: DIW survey conducted in autumn 1996.

among the independent companies as much as 58 per cent faced equity problems.

According to the survey findings, inadequate equity is a general problem which is linked with other serious problems. Companies with an insufficient equity base also had more problems financing investments than other companies. They also reported on obstacles to their access to the market, as, more than other firms surveyed, their sales and distribution systems and their after sales service have been inadequate. This is not surprising as marketing and distribution normally need extensive financial inputs. In general, for the group of companies with an insufficient equity base, unsatisfactory order books and capacity utilization were much more common than in other companies. This was also true for the liquidity situation. All these problems are linked together and give rise to a kind of vicious circle. If investment cannot be undertaken, marketing activities and distribution channels also cannot be improved and, additionally burdened with high wages, profits remain unsatisfactory (see also Belitz (1995)). As a consequence, companies are not able to accumulate and, thus, to improve competitiveness (DIW, IfW and IWH (1996)). Certainly, this is not typical for eastern German manufacturing, but it is typical for many companies, especially newly founded companies, which have not yet found their market niche. In eastern Germany, however, these problems are much more severe than elsewhere.

6.7 Conclusions

The reconstruction of eastern German manufacturing has made substantial progress. Production has expanded at last at respectable rates and more sturdily than in western Germany. Privatization was completed at the end of 1994. Productivity has expanded at high rates and unit labour costs have been drastically reduced. The generous subsidy schemes, as well as the expensive commitments on investment and employment in the course of privatization, have supported this process substantially. Thus, the first step of structural adjustment, the transformation of eastern German manufacturing into the market system, has been completed.

However, the process of restructuring is not finished by far. The second step of structural adjustment is still on the agenda: the integration of eastern German manufacturing into an open economy. It seems that there is still a long way to go to reach this aim:

- Eastern German manufacturing has become oriented to branches where integration into international markets is comparatively low. In addition, export activities are low in all branches.
- However, the adjustment process varies significantly from one company to another. There are, in some respects, differences between plants run by western German or foreign companies on the one hand, and non-affiliated companies, mostly small- and medium-sized, on the other hand.

TABLE 6.6.10

Profit situation perceived by east German manufacturing firms, 1995-1996
(Per cent)

	Per cent of firms achieved in 1995:				*1995 profit situation not estimated*	*Per cent of firms achieved in 1996:*				*1996 profit situation not estimated*
	Acceptable profit	*Low profit*	*Balanced result*	*Significant losses*		*Acceptable profit*	*Low profit*	*Balanced result*	*Significant losses*	
Private firms	16	24	27	30	3	13	26	35	21	5
of which:										
Independent firms	15	26	27	28	4	13	27	35	19	6
Firms owned by west German or foreign firms	17	18	27	35	3	14	23	32	27	4
of which:										
Privatized Treuhand firms	13	20	27	39	1	10	23	37	26	4
Reprivatized Treuhand firms	12	22	26	38	1	10	20	38	27	5
Private firms before 1990	23	34	19	22	2	17	26	34	15	8
Firms founded after 1989	18	26	29	21	6	16	30	32	16	6
Firms owned by the Treuhand	–	4	11	85	–	–	4	27	65	4
Firm size by employees										
1 to 9	11	28	29	26	7	11	25	36	19	9
10 to 19	17	26	29	24	5	14	30	34	16	6
20 to 49	18	26	28	26	2	14	27	36	18	5
50 to 99	14	22	24	38	2	13	25	37	23	3
100 to 199	17	14	23	44	2	12	22	33	30	3
200 to 499	21	15	19	45	1	14	18	26	36	6
500 and more	9	20	20	48	3	10	27	21	39	3
All firms	16	24	27	30	3	13	26	35	21	5

Source: DIW surveys conducted in spring 1995 and autumn 1996.

Externally controlled plants seem to have better conditions for financing new capital formation and for creating a broad supraregional sales structure. Non-affiliated "independent" companies lack capital and liquidity. Only a few of them have been able to create a powerful sales and distribution system or to integrate successfully into networks.

- In the years since unification, economic policy has played a dominant role in the adjustment process. Fast privatization and massive subsidies have aimed at "buying time". In fact, expectations arising from that dual strategy have not always been realized. On the one hand, investment activities have been high and most parts of the capital stock have been renewed. On the other hand, many companies – most of them non-affiliated companies – have not yet fallen in step, especially in supraregional markets.

What can be learnt for the future from the experiences of the first years of economic restructuring? First, that the process of restructuring, i.e. integrating eastern German manufacturing into an open economy, will take time; and secondly, that money cannot buy everything. Under these conditions the question arises if government support should be continued at all. Some economists argue that a fast growing economy would help to overcome the obstacles facing the eastern German economy and that economic policy would not be very effective (Klodt (1994)). Others tend towards direct interventions in order to shift manufacturing potential to the east (Mieth (1995)).

As there are still some locational disadvantages reported in eastern Germany, and also for political reasons, there can be no question but to continue giving government support for the time being (DIW, IfW and IWH (1997)). Clearly, however, in a market system government support cannot play a major role. Economic policy for restructuring eastern German manufacturing should focus on supporting firms in broadening their supranational and export base. As the level of manufacturing activities is very low it should also put emphasis on attracting external investment for a limited period.

It is also clear, however, that economic policy can only support company decisions, it does not guarantee competitiveness. Its impact on economic performance is limited. After all, entrepreneurial initiative is the motive force of economic success. Last but not least, there must be responsible wage policy, with wages better adjusted to the efficiency of companies.

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Discussion of chapter 6

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Dynamics: GDP down, up and catching up

The UN/ECE secretariat is to be congratulated on continuing in this year's *Economic Survey of Europe*, as previously, to tabulate, where appropriate, a memorandum item on the "ex-GDR *Länder*" and hence to invite multi-dimensional consideration of the German eastern *Länder* alongside the 27 transition countries within its remit. Alexander Eickelpasch and I happen also to be contributing to such comparison in the practical context of enterprise restructuring: our Institutes have funds from the European Commission TACIS Programme to evaluate the competition strategies of privatized firms in the German eastern *Länder* and the United Kingdom for use post-privatization in the Russian Federation. His paper describes provision by his Institute, the DIW, of novel time-series and cross-section data on eastern *Länder* microeconomics, which he analyses within a macroeconomic setting. His table 6.1.1 summarizes the dual problem within the objective of "catching up with the western *Länder*". The first problem has been recovery from recession: hit after unification by demand shrinkage and by a severe reduction of productive capacity, the eastern *Länder* have climbed from 31 per cent of the western *Länder* GDP per capita in 1991 to 56 per cent in 1997. The second problem is high comparative labour costs, for productivity (GDP per gainfully employed, as Eickelpasch cites) has risen at a rate two thirds faster than the mean gross wage during 1991 to 1997, but not fast enough to overcome the high unit labour costs which the eastern *Länder* inherited from the process of unification. Eickelpasch shows unit labour costs to have still been 21 per cent above that of the western *Länder* in 1997, against 51 per cent in 1991. He shows (table 6.1.2) how precipitous was the decline in the contribution of manufacturing – from 28 per cent of gross value added in 1990 to 17 per cent in 1991 and to 14 per cent in 1992, at which ratio it has remained virtually constant to 1997. In a word, the issue is of reindustrialization after deindustrialization.

If the comparator is changed from the established market system of the German western *Länder* to the neighbouring transition economies of central Europe, the eastern *Länder* macro-dynamic appears in a better light. Indices of real GDP from the UN/ECE *Survey* and from research recently conducted at my Institute are displayed in the table below. They are nearly identical for 1990 and 1991, but diverge on the degree to which the 1989 level[119] had been attained by 1997. There is no dispute that the eastern *Länder* have shown a better performance on this aggregate than has Hungary, and that Poland, which exceeded the 1989 level already in 1996, is the first ranker. Projecting to 1998, one series puts the eastern *Länder* closer to attaining the 1989 level of GDP than the Czech Republic, and the other series shows it closer than Slovakia. The east German record of regaining the 1989 level with respect to those of its post-communist neighbours is therefore good. The caveat must be made that in recent transition years the composition of GDP and price relatives within it profoundly differ in all these states from that in 1989 and that – because prices are market-clearing and enterprises are free to choose their outputs at those prices – a welfare index for a recent date would show a significantly greater value than in 1989. Even so, the eastern *Länder* have some way still to go to match the product mix typical of a modern long-established market economy. Thus value added by services was by 1996, as Eickelpasch's table 6.1.2 also shows, proportionately (and absolutely, given the GDP relativity) greater than in 1990 – 30 against 12 per cent – but continuingly smaller than in the western *Länder* (37 per cent). Indeed, another study co-authored by Eickelpasch's Institute shows that the eastern *Länder* service sector had edged up from 5.5 per cent to only 9.6 per cent of the all-German sector and was operating at barely half western *Länder* productivity.[120] On a longer perspective, it was only in 1995 that the eastern *Länder* produced the share of all-German GDP shown in the best GDR year (11 per cent) and in 1997 its 12 per cent (as shown by Eickelpasch) was about two fifths of the 28 per cent which the territory contributed to 1936 GDP.[121] Looking ahead, there is poor likelihood of either an early narrowing of that inner German gap or of better growth than in neighbouring transition states: the incremental rates of GDP in the table below for 1997 and 1998 are less than the all-German rates[122] and below those for Hungary, Poland and Slovakia (although better than for the temporarily crisis troubled Czech Republic).

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[119] Stephan's base is GDP at end-1989, whereas the UN/ECE base is year 1989: this accounts for some of the series' divergence.

[120] In 1996, 51 per cent; in the first half of 1997, 43 per cent. DIW, Institut für Weltwirtschaft an der Universität Kiel, Institut für Wirtschaftsforschung Halle, *Gesamtwirtschaftliche und unternehmerische Anpassungsfortschritte in Ostdeutschland*, Siebzehnter Bericht, November 1997, table 4.

[121] M. Kaser, "The economic dimension", in E. Moreton (ed.), *Germany Between East and West* (Cambridge, Cambridge University Press, 1987), p. 123; derived from sources (including UN/ECE, *Economic Survey of Europe Since the War* (Geneva), 1953, table 8), detailed on p. 138.

[122] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, table 2.2.1: 2.2 per cent in 1997 and 2.5 per cent forecast for 1998.

Real GDP, 1990, 1991, 1997 and 1998
(Indices and per cent)

	1990		*1991*		*1997*		*Forecast 1998*	
	ECE	*J. Stephan*	*ECE*	*J. Stephan*	*ECE*	*J. Stephan*	*ECE*	*J. Stephan*
Indices 1989=100								
Czech Republic	98.8	98.8	87.4	86.5	97.5	91.1	99.4	92.9
Slovakia	97.5	97.6	83.3	85.2	96.1	97.0	91.5	100.9
Hungary	96.5	96.6	85.0	86.3	90.1	91.9	93.7	95.5
Poland	88.4	89.6	82.2	83.7	111.8	113.9	118.2	120.1
Eastern *Länder*	84.5	84.4	68.3	65.3	96.0	92.0	97.9	94.2
Annual percentage change								
Czech Republic	-1.2	-1.2	-12.0	-14.2	1.3	1.2	1.9	2.0
Slovakia	-2.5	-2.5	-14.5	-14.5	6.5	5.9	5.0	4.0
Hungary	-3.5	-3.5	-11.9	-11.9	4.0	4.4	4.0	4.0
Poland	-11.6	-11.6	-7.1	-7.0	6.9	6.9	5.7	5.5
Eastern *Länder*	-15.5	-15.6	-19.2	-22.7	1.6	1.6	2.0	2.4

Source: UN/ECE, *Economic Survey of Europe*, 1998 No. 1, tables 3.1.1 and B.1 (for the 1998 forecast the percentage is applied to the 1997 outcome); J. Stephan, *Economic Transition in Hungary and East Germany. Gradualism and Shock Therapy in Catch-Up Development* (London, Macmillan, 1998), p. 2 (publication of research at the Institute for German Studies, University of Birmingham, 1996-1997).

Dynamics: the Mezzogiorno problem

The millennium will have been turned before the 1989 GDR equivalent aggregate is reached, on either of the following table's projections. Subsequently, the objective for the eastern *Länder* is to reach the mean per capita economic activity of the western *Länder*. In the German context, this is a "Mezzogiorno problem" – an issue posed in that form since unification, with estimates for catching up ranging from 20 to 40 years.[123] There is a parallel in the EU context of eastern enlargement. However it is described, the richer partner undertakes a commitment to transfer substantial resources to raise the GDP per capita of the poorer partner to its own level. Eickelpasch considers the magnitude of those transfers, although pointing out that his tabulation by type of government programme (table 6.2.2) understates the total by not including *Land* and local subsidies. That total of western *Länder* transfers to the eastern *Länder* has run at about 5 per cent of GDP since unification (a range annually between 4.8 and 6.1 per cent), and it is relevant that the EC Commissioner for the budget, Erkki Liikanen, has proposed a limit of 4 per cent of EU GDP for prospective transfers to new members (under structural funds and CAP).[124]

Eickelpasch's statistics (table 6.1.1) also invite comparison of the "gap" at unification with that of past and future EU accessions. In 1991, as he shows, the eastern *Länder* GDP per capita was 31 per cent of that of the western *Länder*: this is a smaller gap than between Portugal and the average for the EU (27 per cent in 1986) and about the same as a range of first phase EU candidates (Hungary 36 per cent and Poland 32 per cent).[125] By 1997 the eastern *Länder* gap had shrunk to 58 per cent, which is narrower than the past gap for Ireland (53 per cent in 1973) and the prospective one for Slovenia (50 per cent). By coincidence, the ratio of eastern to western *Länder* per capita GDP in 1997 was that long experienced by south to north Italy (58 per cent over 1971-1990), but while the eastern *Länder* have been closing the gap, the Mezzogiorno gap has widened (55 per cent in 1995).[126]

To close the gap within Germany, the average western *Land* resident has paid more than DM 3,000 annually to the average eastern *Land* resident and the average eastern *Land* resident has received DM 13,000 annually. Northern provision for the Mezzogiorno has also been heavy – in 1988, 73 per cent of southern GDP was inflow from the north. Just as western *Land* voters are now questioning the need for their tax burden, so the Italian government found public sector transfers to have "crowded out" private investment and this year has established a new department within the Treasury to help coordinate the two flows.

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[123] For a summary see M. Kaser, "The eastern *Länder* as a transition economy" in J. Hölscher and A. Hochberg (eds.), *East Germany's Economic Development since Unification: Domestic and Global Aspects* (London, Macmillan, 1998), p. 57.

[124] J. Eatwell et al., *Not "Just Another Accession": The Political Economy of EU Enlargement to the East* (London, Institute for Public Policy Research, 1997), p. 25, citing work by H. Grabbe and K. Hughes; they also point out that the budgetary cost to present members would partly be offset by real income gains to their economies by increased access to new member markets (citing work by R. Baldwin, J. François and R. Portes, which, the book notes, does not allow for redundancies in either group occasioned by increased competition).

[125] *More Members for the EU?*, Centre for Finnish Business and Policy Studies, Helsinki, 1997, p. 23.

[126] Data on Italy are from government documentation summarized by J. Blitz, "Now the Mezzogiorno climbs to the top of Prodi's agenda", *Financial Times*, 27 May 1998, and amplified in direct communication with that author.

A pervasive political issue is, of course, that voters as much in the eastern *Länder* as in southern Italy perceive another feature of the gap – that of unemployment rates. The eastern *Länder* rate was 21.3 per cent in February 1998, compared with a western *Land* rate of 10.4 per cent. The Mezzogiorno gap is still wider – 21 per cent in 1995, against 7.8 per cent in the north – and as the national average unemployment rate has edged up (11.9 per cent in 1995 to 12.1 per cent in 1997), it has gone higher in the Mezzogiorno (22.4 per cent in 1997). In his final paragraphs Eickelpasch appreciates that continued resource transfer by the Federal government is politically under question and that divergent academic opinions are voiced on the outcome of a government industrial policy to revive eastern *Land* manufacturing: "money cannot buy everything", he concludes.

Dynamics: upgrading and downsizing

The bulk of Eickelpasch's paper analyses questionnaires from a sample of eastern *Land* enterprises enlarged from 1,700 firms in 1991 to 3,800 firms in 1996 and ongoing. Of particular value is a longitudinal extract of 1,200 firms whose 1996 experience can be precisely matched to theirs of 1995 – they accounted for two fifths of the whole sample in 1995 and one third of that of 1996. One general conclusion he draws from the full sample (table 6.6.2) is that between 1991 and 1995 enterprises found their competitive situation improving (85 per cent declared market problems in 1991, but 52 per cent in 1995), but worsening in 1996 (55 per cent faced problems); of the identical (smaller) sample, 51 per cent had market problems in 1995, but 59 per cent in 1996. The year 1996 was seemingly not a good one: 79 per cent of firms declared that they had made no progress on problems which they had encountered in 1995.

The substance of the various problems encountered may be broadly compared with the corresponding ones reported in a sample of Czech, Hungarian and Polish firms in 1994.[127] The sample is smaller (506 firms) and was confined to firms employing between 100 and 1,500 persons, whereas there was no size boundary for the DIW surveys reported by Eickelpasch. The central European sample shared the eastern *Länder* experience of substantial personnel downsizing since 1990, but the effect of privatization (or of comparison between state and private enterprises) was not so much on cost reduction as on revenue expansion, and – because entrepreneurs were readier to undertake risks – the variance of profitability in the private sector was wider than in the state sector. This conclusion appears to be derivable from the DIW samples: in 1996 more than half the firms designated their three most serious problems as cost-related (Eickelpasch's table 6.6.3); they did face increasing competition (also more than half the respondents), but revenue constraints (such as inadequate distribution or after sales service) affected proportionately far fewer.[128] The German enterprise reports of a decreasing problem of lack of investment finance (and the disappearance of plant/equipment overcapacity as a problem) testifies to the west-to-east capital flow and to the investment guarantees contracted under many Treuhand sales.

By upgrading fixed assets and downsizing personnel, east German manufacturing should in principle be in much better form than before unification and with respect to firms in neighbouring transition states (which experienced similar market destruction). The eastern *Länder*, however, had many variant characteristics. First, they were immediately absorbed into a market economy and into the EU, having a complete set of laws and practices applicable forthwith. Secondly, not only were they precluded from the devaluation which the central European states undertook, thereby enhancing competitiveness, but, as Eickelpasch points out, they encountered greater competition by reason of currency appreciation. The rise in labour cost was the greater because of the application of social charges (which in his table 6.6.3 is given as firms' most numerously cited problem). The federal government's policy in this regard was based on many considerations, but the halting of potentially mass migration from east to west was uppermost. Finally, the embrace of western *Länder* trade unions, of employer groups and of tariff uniformity raised (as already noted above) money wages in excess of productivity gains. By the date of the last DIW survey reported by Eickelpasch, autumn 1996, five manufacturing branches in the eastern *Länder* had reached full parity with western *Länder* wage tariffs, another four were 90 per cent or more in approximating to that parity, ten were 80 per cent or more towards it, and only four were below 80 per cent of parity.[129] However, the dispersion of firms around the standard tariff had widened and there were significant differences in the DIW sample for 1996 between and among private firms and the few remaining in the hands of the Treuhand's successors (42 per cent of the former were paying less than the tariff and only 19 per cent of the latter).[130] Agreement by the Federal government, employers and trade unions in 1997 has moderated the rate of progress to parity.

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[127] R. Frydman, M. Hessel and A. Rapaczynski, *Why Ownership Matters: Politicization and Entrepreneurship in the Restructuring of Enterprises in Central Europe*, Economic Research Reports, No. 98-14, C.V. Starr Center for Applied Economics, New York University (New York), April 1998.

[128] This interpretation treats "delays in recouping debts" as a cost (in interest and debt collection charges) rather than as mis-selling (to insolvent customers).

[129] Tarifniveau Ost/West: Stand 30.6.1996, *WSI-Tarifarchiv 1996*.

[130] K. Brenke and A. Eickelpasch, *Lage und Perspektiven der Unternehmen in Ostdeutschland. Ergebnisse einer Umfrage* (Berlin, Ducker & Humblot, 1997), pp. 16-17 and table 6 (publication kindly supplied by the authors).

Dynamism: capital and labour ratios

It is significant, however, that in the 1996 sample 47 per cent of independent firms, whether established as such or taken over from the Treuhand, were paying less than the wage tariff, while only 22 per cent of those in west German or foreign ownership were paying less than the tariff, the share being slightly smaller (21 per cent) in those taken over from the Treuhand. In principle this should mean that firms in west German or foreign ownership became less competitive, and Eickelpasch points out that the problem sensitivity of these and of independent firms are remarkably similar. He attributes that outcome to the Treuhand selling into west German or foreign ownership firms in branches suffering from worldwide overcapacity, or previously more dependent on CMEA markets. It is the case that, if buyers had other transition economies in mind as continuing markets, the expectations were misplaced. The DIW survey showed that only 6 per cent of sales by such firms went to eastern Europe (table 6.6.7). A further reason for western *Länder* purchase could be that west German companies bought enterprises to preclude potential competition. Of the 85 per cent of firms which the Treuhand sold to west Germans, nine out of ten were in the same branch.[131] Eickelpasch notes that west German or foreign owners in the 1996 sample invested an average of DM 30,000 per employee against DM 19,000 per employee by independent east German owners, and that the former group overall invested less per employee in 1996 than in 1995 and would invest less in 1997 than in 1996. West German and foreign owners are dominant in this regard because they possess on average larger establishments in the eastern *Länder* than do independent owners. Because they are larger, they number proportionately less in the DIW surveys (22 per cent of all firms surveyed), but they account for 44 per cent of the employees (as table 6.6.1 shows). Some western *Länder* owners have been perceived as using their eastern *Länder* subsidiaries as a "long workbench", that is attributing lower technologies to them. Eickelpasch observes that "west German or foreign ownership does not always seem to be an advantage for eastern German firms".

It is in the interests of competitiveness that the investment undertaken by independent, west German and foreign owners has pushed up the capital-labour ratio (38 in 1991 to 54 in 1996)[132] faster than in the western *Länder*. To the extent that this has been accomplished by reducing employment, the obverse is the financial and social cost of unemployment, the heavier impact of which on the eastern than on the western *Länder* is noted above. Government employment (Federal, *Land* and local) has concurrently been sharply reduced – from 1.78 million in 1991 to 1.05 million in 1997 (from 24 to 17 per cent of the gainfully occupied).[133] Lay-offs have primarily been among the lowest paid, and low wage earners are disproportionately female.[134] "Leaner" employment, longer hours and lower social charges have enhanced eastern *Länder* competitiveness. Hourly labour compensation is not only well below the western *Länder* average but below those of the higher cost EU competitors, although still far above those of transition central Europe.[135]

Eickelpasch has illuminated from the DIW surveys the problems confronting the eastern *Länder* economy: the framework of *Mitbestimmung* invites partnership in their solution from government at all levels and from employers and employees in a variety of entities. The UN/ECE spring seminar in Geneva, at which some of these issues were ventilated, is a small part of the contribution which international agencies can make to their solution.

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[131] J. Müller, "Strukturelle Auswirkungen der Privatisierung durch die Treuhandanstalt", in W. Fischer et al. (eds.), *Treuhandanstalt – Das unmögliche Wagen* (Berlin, Akademie Verlag, 1993), p. 369.

[132] Ratio of capital stock to employment. *Germany – Selected Issues*, IMF Staff Country Report, No. 97/101 (Washington, D.C.), October 1997, table III-7, which also calculates the speed of convergence towards the west German ratio.

[133] *Informationsdienst des Instituts der deutschen Wirtschaft*, No. 16, 1998, p. 5.

[134] J. Hunt, "The transition in east Germany: when is a ten-point fall in the gender wage gap bad news?", *CEPR Discussion Paper Series*, No. 1805 (London), February 1998.

[135] In 1996 hourly compensation in eastern *Länder* manufacturing was 63 per cent of the western *Länder* mean; in Austria it was 78 per cent, Belgium 82 per cent, Denmark 77 per cent, Netherlands 73 per cent and Sweden 77 per cent of that mean; but the Czech Republic, Hungary and Poland were merely about 7 per cent. *Germany – Selected Issues*, IMF Staff Country Report No. 97/101 (Washington, D.C.), October 1997, table III-5.

PART THREE

STATISTICAL APPENDIX

For the user's convenience, as well as to lighten the text, the *Economic Survey of Europe* includes a set of appendix tables showing time series for main economic indicators over a longer period. The data are presented in two sections, following the structure of the text: *Appendix A* provides macroeconomic indicators for the market economies of western Europe and North America for 1983-1997, *Appendix B* does the same for the east European countries, the Baltic states and the Commonwealth of Independent States for 1980-1997.

Data for the transition economies are preliminary because re-estimated historical series are not yet available for all countries, and longer time series could in some instances be obtained only by splicing older data with the new statistics (as explained in the notes to the tables).

Data were compiled from international and national statistical sources. Regional aggregations are ECE secretariat estimates based, variously, on 1990-1992 weights. The figures for 1997 are based on data available at the beginning of June 1998.

APPENDIX TABLE A.1

Real GDP in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	1.9	2.5	2.7	3.1	3.2	4.0	3.4	3.3	1.5	1.2	-0.1	2.5	2.7	2.0	2.7
European Union [a]	1.7	2.3	2.6	2.9	2.9	4.2	3.5	3.0	1.6	0.9	-0.5	2.9	2.5	1.7	2.6
4 major countries	1.8	2.3	2.5	2.9	2.8	4.2	3.3	2.9	1.6	1.0	-0.5	3.0	2.3	1.4	2.3
France	0.7	1.3	1.9	2.5	2.3	4.5	4.3	2.5	0.8	1.2	-1.3	2.8	2.1	1.6	2.3
Germany [b]	1.8	2.8	2.0	2.3	1.5	3.7	3.6	5.7	5.1	2.2	-1.2	2.7	1.8	1.4	2.2
Italy	1.2	2.6	2.8	2.8	3.1	3.9	2.9	2.2	1.1	0.6	-1.2	2.2	2.9	0.7	1.5
United Kingdom	3.7	2.3	3.8	4.3	4.8	5.0	2.2	0.4	-2.0	-0.5	2.1	4.3	2.7	2.2	3.3
17 smaller countries	2.1	2.9	3.0	3.3	4.1	3.6	3.5	3.9	1.4	1.5	0.8	1.6	3.3	3.0	3.6
Austria	2.8	0.3	2.2	2.3	1.7	3.2	4.2	4.6	3.4	1.3	0.5	2.5	2.1	1.6	2.5
Belgium	–	2.5	1.0	1.5	2.4	4.7	3.6	3.0	1.6	1.5	-1.5	2.4	2.1	1.5	2.9
Cyprus	5.3	8.8	4.7	3.8	7.0	8.5	7.9	7.4	0.6	9.8	0.7	5.8	5.5	1.9	2.4
Denmark	2.5	4.4	4.3	3.6	0.3	1.2	0.6	1.4	1.3	0.2	1.5	4.2	3.1	3.5	3.4
Finland	2.7	3.0	3.4	2.4	4.1	4.9	5.7	–	-7.1	-3.6	-1.2	4.5	5.1	3.6	5.9
Greece	0.4	2.8	3.1	1.6	-0.5	4.5	3.5	-0.6	3.4	0.4	-0.9	1.5	2.1	2.7	3.5
Iceland	-2.2	4.1	3.3	6.3	8.5	-0.1	0.3	1.2	1.3	-3.3	0.9	3.5	1.1	5.5	5.0
Ireland	-0.2	4.4	3.1	-0.4	4.7	5.4	5.9	8.4	1.9	3.9	3.1	7.0	10.4	7.7	10.5
Israel	2.6	2.2	4.4	3.7	6.3	3.5	0.2	7.1	6.3	6.6	4.0	6.3	6.4	4.5	1.9
Luxembourg	3.0	6.2	2.9	7.8	2.3	10.4	9.8	2.2	6.1	4.5	8.7	4.2	3.8	3.0	3.7
Malta	-0.6	0.9	2.6	3.9	4.1	8.4	8.2	6.3	6.3	4.7	4.5	2.1	7.3	4.2	2.8
Netherlands	1.7	3.3	3.1	2.8	1.4	2.6	4.7	4.1	2.3	2.0	0.8	3.2	2.3	3.3	3.4
Norway	3.5	5.9	5.2	3.6	2.0	-0.1	0.9	2.0	3.1	3.3	2.7	5.0	4.1	5.5	3.4
Portugal	-0.2	-1.9	2.8	4.1	6.4	4.9	4.9	4.6	2.3	1.8	0.3	0.7	1.9	3.0	3.5
Spain	2.2	1.5	2.6	3.2	5.6	5.2	4.7	3.7	2.3	0.7	-1.2	2.2	2.7	2.3	3.4
Sweden	1.8	4.0	1.9	2.3	3.1	2.3	2.4	1.4	-1.1	-1.4	-2.2	3.3	3.9	1.3	1.8
Switzerland	1.0	1.8	3.7	2.9	2.0	2.9	3.9	2.3	-0.8	-0.1	-0.5	0.5	0.8	-0.2	1.1
Turkey	5.0	6.7	4.2	7.0	9.5	2.1	0.3	9.3	0.9	6.0	8.0	-5.5	7.2	7.0	6.3
North America	3.9	6.7	3.9	3.0	3.0	3.9	3.3	1.2	-1.0	2.6	2.3	3.5	2.0	2.6	3.8
Canada	2.8	5.7	5.4	2.6	4.1	4.9	2.5	0.3	-1.9	0.9	2.5	3.9	2.2	1.2	3.7
United States	4.0	6.8	3.7	3.0	2.9	3.8	3.4	1.3	-1.0	2.7	2.3	3.5	2.0	2.8	3.8
Total above	2.9	4.6	3.3	3.0	3.1	3.9	3.3	2.2	0.2	1.9	1.1	3.0	2.3	2.3	3.2
Memorandum item:															
Japan	2.3	3.9	4.4	2.9	4.2	6.2	4.8	5.1	3.8	1.0	0.3	0.6	1.5	3.9	0.9
Total above, *including Japan*	2.8	4.5	3.5	3.0	3.3	4.3	3.6	2.7	0.8	1.7	1.0	2.6	2.2	2.6	2.9

Source: National statistics.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.2

Real private consumption expenditure in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	1.7	1.8	2.7	4.2	3.6	3.8	3.1	3.4	2.2	1.7	0.1	1.3	1.9	2.3	2.2
European Union [a]	1.5	1.5	2.8	4.1	3.9	4.1	3.4	3.0	2.2	1.6	-0.3	1.6	1.7	2.0	2.1
4 major countries	1.8	1.8	2.7	4.5	3.9	4.3	3.2	3.0	2.2	1.5	-0.2	1.5	1.7	1.9	1.8
France	0.9	1.1	2.4	3.9	2.9	3.3	3.1	2.7	1.4	1.3	0.2	1.4	1.7	2.0	0.9
Germany [b]	1.5	1.8	1.7	3.5	3.4	2.7	2.8	5.4	5.6	2.8	0.1	1.2	1.8	1.4	0.2
Italy	0.7	2.5	3.1	4.2	4.3	4.6	3.6	2.5	2.7	1.3	-3.4	0.9	1.4	1.2	2.4
United Kingdom	4.5	2.0	3.8	6.8	5.3	7.5	3.2	0.6	-2.2	-0.1	2.5	2.8	1.7	3.6	4.6
17 smaller countries	1.5	1.7	2.7	3.6	3.1	2.9	3.0	4.1	2.3	2.0	0.5	0.9	2.3	3.1	3.1
Austria	5.0	-1.3	1.9	2.2	2.9	3.3	3.7	3.8	2.8	3.0	0.7	1.7	2.9	2.4	0.7
Belgium	-0.9	0.7	2.0	2.0	2.3	3.2	3.7	2.9	2.9	2.3	-1.4	1.4	1.1	1.3	2.1
Cyprus	7.3	4.5	5.9	1.7	5.5	10.5	6.9	9.0	9.9	3.2	-5.0	4.2	10.9	2.5	-1.1
Denmark	2.6	3.4	5.0	5.7	-1.5	-1.0	-0.4	–	1.2	1.9	2.0	6.9	2.2	2.8	4.1
Finland	3.1	3.1	3.7	4.0	5.2	5.1	4.3	–	-3.6	-4.9	-2.9	1.9	4.6	3.8	3.1
Greece	0.3	1.7	3.9	0.7	1.2	3.6	4.3	2.1	2.3	1.8	0.1	1.5	2.2	2.3	2.5
Iceland	-5.6	3.7	4.2	6.9	16.2	-3.8	-4.2	0.5	4.1	-4.5	-4.4	1.8	4.2	6.4	6.0
Ireland	0.9	2.0	4.6	2.0	3.3	6.1	6.0	2.2	2.2	4.1	2.2	6.1	4.2	6.3	7.5
Israel	8.7	-6.9	1.3	15.1	8.9	4.5	0.4	5.6	7.2	7.8	7.3	9.2	7.3	5.2	3.3
Luxembourg	0.5	1.4	2.7	5.7	4.6	4.6	5.1	5.7	6.3	-0.9	1.7	2.4	2.4	1.9	2.8
Malta	1.4	4.0	5.0	1.4	0.5	9.0	9.2	3.8	3.8	4.3	0.8	2.3	10.3	6.0	2.8
Netherlands	0.9	1.2	2.8	2.6	2.7	0.8	3.5	4.2	3.1	2.5	1.0	2.2	1.8	3.0	3.1
Norway	1.9	3.2	9.4	5.0	-0.8	-2.0	-0.6	0.7	1.5	2.2	2.2	4.1	2.6	4.7	3.4
Portugal	-1.4	-2.9	0.7	5.6	5.3	5.5	2.5	5.7	4.1	5.6	0.5	1.0	1.0	2.2	2.6
Spain	0.3	-0.2	3.5	3.3	5.8	4.9	5.7	3.6	2.9	2.2	-2.2	0.9	1.6	1.9	3.1
Sweden	-2.4	1.4	2.7	4.4	4.6	2.4	1.2	-0.4	0.9	-1.4	-3.1	1.8	0.8	1.3	2.0
Switzerland	1.7	1.6	1.4	2.8	2.1	2.2	2.2	1.5	1.6	0.1	-0.9	0.9	0.9	0.7	0.8
Turkey	6.7	8.1	-0.6	5.8	-0.3	1.2	-1.0	13.1	1.9	4.0	8.6	-5.4	4.8	8.5	6.0
North America	5.0	5.1	4.7	4.0	3.2	4.0	2.4	1.6	-0.7	2.7	2.8	3.3	2.4	2.6	3.3
Canada	2.9	4.5	5.2	4.0	4.1	4.4	3.6	1.3	-1.4	1.8	1.9	3.1	1.7	2.4	4.1
United States	5.2	5.2	4.7	4.0	3.1	3.9	2.3	1.7	-0.6	2.8	2.9	3.3	2.4	2.6	3.3
Total above	3.4	3.5	3.7	4.1	3.4	3.9	2.8	2.5	0.7	2.2	1.4	2.3	2.1	2.4	2.8
Memorandum item:															
Japan	3.3	2.6	3.3	3.5	4.2	5.3	4.8	4.4	2.5	2.1	1.2	1.9	2.1	2.9	1.1
Total above, *including Japan*	3.3	3.3	3.6	4.0	3.5	4.1	3.1	2.8	1.0	2.2	1.4	2.2	2.1	2.5	2.5

Source: National statistics.

Note: See appendix table A.1.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.3

Real general government consumption expenditure in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	2.6	1.6	3.0	2.8	2.9	2.2	1.2	2.8	2.5	2.2	1.3	0.8	1.2	1.9	0.4
European Union[a]	1.9	1.6	2.4	2.5	2.6	2.3	1.1	2.4	2.3	2.2	0.9	1.1	0.9	1.5	0.2
4 major countries	1.8	1.7	1.9	2.1	2.1	2.3	0.1	2.0	1.8	2.4	0.8	1.3	0.7	1.8	-0.1
France	2.1	1.2	2.3	1.7	2.8	3.4	0.4	2.1	2.8	3.4	3.5	1.1	–	2.6	1.2
Germany[b]	0.2	2.5	2.1	2.5	1.5	2.1	-1.6	2.2	0.4	4.1	-0.5	2.1	2.0	2.6	-0.4
Italy	3.1	2.1	3.1	2.5	3.2	2.7	0.9	1.2	1.7	1.2	0.5	-0.6	-1.0	0.2	-0.7
United Kingdom	2.1	0.8	-0.1	1.6	1.0	0.7	1.4	2.5	2.6	-0.1	-0.2	2.2	1.3	1.2	-0.5
17 smaller countries	4.4	1.4	5.0	4.1	4.5	2.1	3.3	4.2	3.8	2.0	2.2	-0.1	2.1	2.0	1.4
Austria	1.7	0.8	1.3	1.8	0.2	1.1	1.4	1.3	2.2	2.0	2.7	2.5	–	0.1	0.9
Belgium	0.3	0.6	2.5	1.9	0.1	-0.9	-0.9	-0.5	2.0	0.1	1.2	1.6	0.9	1.8	0.9
Cyprus	6.1	3.8	3.7	3.6	5.3	10.5	1.9	17.4	3.9	13.8	-14.3	4.1	2.9	11.9	7.1
Denmark	–	-0.4	2.5	0.5	2.5	0.9	-0.6	-0.4	-0.1	0.4	3.0	2.0	2.0	2.4	2.9
Finland	3.7	2.7	4.5	3.1	4.3	2.3	2.3	3.8	2.5	-2.2	-5.3	-0.3	1.9	3.5	-0.3
Greece	2.7	3.0	3.2	-0.8	0.9	5.7	3.3	2.2	2.0	0.9	0.9	-0.1	8.0	0.5	-0.1
Iceland	4.7	0.6	6.5	7.3	6.5	4.7	3.0	4.4	3.1	-0.8	2.3	3.7	1.3	1.0	1.5
Ireland	-0.4	-0.7	1.8	2.6	-4.8	-5.0	-1.3	5.4	2.9	2.4	0.5	4.8	3.9	2.9	2.5
Israel	-4.6	5.8	3.6	-6.5	14.1	-2.6	-8.5	6.6	4.6	-0.3	5.4	0.3	1.5	5.5	2.3
Luxembourg	1.9	2.2	2.0	2.7	4.7	4.9	3.9	3.1	3.9	1.5	3.7	2.0	2.2	3.3	3.9
Malta	-1.1	-2.5	5.6	4.4	9.1	6.0	12.7	5.7	10.9	8.9	6.0	6.4	7.9	8.0	0.1
Netherlands	2.3	–	2.4	3.6	2.6	1.4	1.5	1.6	1.5	1.7	1.5	0.6	0.6	1.2	2.2
Norway	2.8	0.8	2.4	1.9	4.6	-0.1	1.9	4.9	4.3	5.3	2.2	0.7	1.9	3.2	3.0
Portugal	3.8	0.2	6.4	7.2	3.8	8.1	5.4	5.9	10.8	0.4	0.9	1.3	2.4	1.8	1.9
Spain	3.9	2.4	5.5	5.4	8.9	4.0	8.3	6.6	5.6	4.0	2.4	-0.3	1.8	0.1	0.7
Sweden	0.8	2.3	2.4	1.3	1.0	0.6	2.1	2.6	2.8	–	0.2	-0.7	-0.9	-0.2	-2.1
Switzerland	3.8	1.2	3.2	3.7	1.8	4.3	4.2	4.7	3.5	0.7	-0.1	2.0	-0.8	0.7	-0.3
Turkey	16.6	1.9	14.1	9.2	9.4	-1.1	0.8	8.0	4.5	2.8	8.6	-5.5	6.8	8.6	4.5
North America	2.1	1.6	4.8	4.3	2.1	2.2	2.7	2.4	1.1	–	-0.3	0.2	-0.2	-0.1	1.1
Canada	1.7	1.1	4.3	1.9	1.4	4.6	2.8	3.7	2.8	1.0	-0.2	-1.8	-0.4	-1.3	-0.1
United States	2.1	1.6	4.8	4.6	2.2	2.0	2.7	2.3	1.0	-0.1	-0.3	0.4	-0.1	–	1.2
Total above	2.3	1.6	3.9	3.6	2.5	2.2	2.0	2.6	1.8	1.1	0.5	0.5	0.5	0.9	0.7
Memorandum item:															
Japan	2.5	2.3	0.3	5.1	1.6	2.3	2.0	1.5	2.0	2.0	2.4	2.4	3.3	1.5	-0.2
Total above, *including Japan*	2.4	1.7	3.3	3.8	2.4	2.2	2.0	2.4	1.8	1.2	0.8	0.8	0.9	1.0	0.6

Source: National statistics.

Note: See appendix table A.1.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.4

Real gross domestic fixed capital formation in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	0.5	1.2	3.0	4.3	7.4	8.0	6.8	4.2	-0.4	-0.9	-4.9	1.8	4.1	1.6	2.7
European Union [a]	0.3	1.1	2.7	4.0	5.7	8.6	7.2	3.8	-0.5	-1.0	-6.5	2.5	3.9	1.0	2.5
4 major countries	0.9	2.1	1.7	3.2	5.0	8.3	6.2	3.4	–	-0.3	-6.2	2.5	2.8	-0.1	1.3
France	-3.6	-2.6	3.2	4.5	4.8	9.6	7.9	2.8	–	-2.8	-6.7	1.3	2.5	-0.5	0.2
Germany [b]	3.1	0.1	-0.5	3.3	1.8	4.4	6.3	8.5	6.0	3.5	-5.6	3.5	0.8	-1.2	0.2
Italy	-1.0	3.4	0.5	2.0	4.4	6.9	4.4	3.6	0.8	-1.8	-12.8	0.5	7.1	0.4	0.6
United Kingdom	5.0	8.9	4.2	2.6	10.3	13.9	6.0	-3.5	-9.5	-1.5	0.6	4.3	1.5	1.5	4.8
17 smaller countries	-0.2	-0.5	5.6	6.5	12.0	7.4	8.0	5.7	-1.3	-2.0	-2.3	0.5	6.7	5.0	5.5
Austria	0.4	0.1	6.9	2.4	4.4	6.8	6.3	6.6	6.3	0.1	-2.0	8.4	1.9	2.4	3.6
Belgium	-5.9	2.5	3.9	3.5	6.3	16.4	11.4	9.6	-4.7	1.3	-3.6	-0.1	3.2	0.6	5.5
Cyprus	-2.2	21.5	-7.7	-7.1	4.5	10.6	20.0	-2.8	-1.6	16.2	-12.8	-2.7	-1.5	2.2	-5.2
Denmark	1.9	12.9	12.6	17.1	-3.8	-6.6	1.0	-1.7	-5.7	-4.2	-5.1	1.9	11.5	7.2	7.2
Finland	3.7	-2.1	2.2	-0.4	4.9	9.8	14.8	-4.1	-20.3	-16.9	-19.2	0.2	11.3	8.4	11.3
Greece	-1.3	-5.7	5.2	-6.2	-5.1	8.9	10.1	9.4	-4.6	1.5	-2.0	0.5	7.3	9.4	10.9
Iceland	-12.7	9.3	1.0	-1.5	18.8	-0.2	-7.9	3.0	2.0	-11.3	-11.4	-1.1	-2.8	26.5	9.9
Ireland	-9.3	-2.5	-7.7	-2.8	-1.1	0.4	12.9	10.4	-7.4	-1.3	-3.4	10.2	9.6	15.9	15.2
Israel	12.8	-11.9	-7.7	0.1	14.4	-1.6	-3.5	23.0	38.8	7.2	3.6	8.7	12.0	6.8	-5.9
Luxembourg	-11.8	0.1	-9.5	31.0	17.9	15.0	7.0	2.7	31.6	-9.0	28.4	-14.9	3.5	-1.7	8.0
Malta	15.8	-7.0	-4.0	-8.7	30.7	6.1	1.0	17.9	–	-0.2	11.1	6.8	17.8	-4.9	-5.5
Netherlands	2.5	5.8	7.0	6.9	0.9	4.5	4.9	1.6	0.2	0.6	-2.8	2.2	5.0	6.1	6.2
Norway	5.4	1.0	-4.0	7.6	0.3	-1.8	-6.9	-10.8	-0.4	-3.1	4.3	6.9	1.4	9.6	12.6
Portugal	-7.1	-17.4	-3.5	10.9	18.0	10.5	4.8	7.1	2.9	4.6	-6.2	4.5	3.6	5.2	13.5
Spain	-2.4	-6.9	6.1	9.9	14.0	13.9	13.6	6.6	1.6	-4.4	-10.5	2.4	7.8	0.9	4.7
Sweden	1.9	6.9	6.3	0.3	8.2	6.6	11.3	1.3	-8.9	-10.8	-17.2	2.0	12.4	3.7	-4.8
Switzerland	4.1	4.1	5.3	7.9	7.4	6.9	5.8	2.6	-2.9	-6.6	-2.7	6.5	1.9	-2.7	-0.8
Turkey	2.6	0.9	11.5	8.4	45.1	-1.0	2.2	15.9	1.2	5.5	26.4	-16.0	9.1	14.1	6.4
North America	6.4	14.6	6.4	2.2	1.2	2.2	2.3	-1.5	-6.4	4.7	4.5	6.6	3.7	7.2	6.9
Canada	0.1	2.6	10.1	5.4	10.7	9.9	5.9	-3.6	-3.6	-1.3	-2.8	7.1	-2.8	4.8	11.4
United States	7.0	15.6	6.1	1.9	0.4	1.5	2.0	-1.4	-6.6	5.2	5.1	6.5	4.3	7.4	6.5
Total above	3.5	7.9	4.7	3.2	4.3	5.1	4.5	1.3	-3.4	1.9	-0.2	4.2	3.9	4.4	4.8
Memorandum item:															
Japan	-1.1	4.3	5.0	4.8	9.1	11.5	8.2	8.5	3.3	-1.5	-2.0	-0.8	1.7	9.5	-3.6
Total above, *including Japan*	2.8	7.4	4.8	3.5	5.1	6.1	5.1	2.4	-2.4	1.4	-0.5	3.4	3.6	5.2	3.5

Source: National statistics.

Note: See appendix table A.1.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.5

Real total domestic demand in the ECE market economies, 1983-1997
(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	1.5	1.9	2.6	4.1	4.1	4.5	3.6	3.4	1.2	1.2	-1.1	1.9	2.6	1.7	2.4
European Union[a]	1.3	1.6	2.5	3.9	3.9	4.9	3.8	2.9	1.4	1.0	-1.9	2.6	2.2	1.4	2.2
4 major countries	1.7	2.0	2.2	4.0	3.7	4.9	3.2	2.7	1.3	1.2	-1.7	2.6	1.9	1.1	1.9
France	-0.7	0.4	2.5	4.5	3.3	4.7	3.9	2.8	0.6	0.2	-2.2	3.0	1.8	1.0	0.9
Germany[b]	2.4	1.9	1.0	3.3	2.4	3.6	2.9	5.2	4.7	2.8	-1.4	2.7	2.0	0.8	1.2
Italy	0.3	3.0	3.0	3.5	4.3	4.0	3.1	2.6	1.8	0.7	-5.1	1.2	2.0	0.5	2.5
United Kingdom	5.1	2.8	2.9	4.9	5.3	7.9	2.9	-0.6	-3.1	0.2	2.0	3.4	1.8	2.5	3.5
17 smaller countries	1.1	1.7	3.2	4.5	4.8	3.6	4.4	4.7	1.0	1.2	0.1	0.7	4.0	2.8	3.3
Austria	3.5	1.6	1.9	2.1	2.6	3.2	3.0	4.3	3.6	1.4	0.8	3.7	2.3	1.4	2.4
Belgium	-2.2	2.2	1.0	2.5	3.3	5.0	4.1	3.5	1.2	1.9	-1.6	1.4	1.5	1.2	2.2
Cyprus	4.9	9.3	2.2	-1.5	5.6	11.3	9.7	6.3	5.1	9.3	-9.6	6.6	8.1	3.2	-0.7
Denmark	1.4	5.1	5.4	6.1	-2.2	-1.2	0.5	-1.0	-0.4	-0.1	0.8	5.7	4.6	3.3	4.3
Finland	2.6	2.2	2.9	2.2	5.2	6.6	7.6	-1.3	-9.2	-6.4	-6.4	3.8	4.8	3.7	4.3
Greece	0.4	0.2	5.2	-0.9	-1.0	6.6	4.0	1.6	2.8	1.6	-0.3	5.1	4.0	3.9	4.0
Iceland	-8.1	6.0	2.9	4.8	15.6	-0.9	-4.3	1.5	5.2	-5.3	-4.1	1.5	3.2	7.5	5.8
Ireland	-2.2	1.1	1.2	1.2	-0.2	2.3	7.3	6.3	–	–	0.7	6.4	6.4	8.4	7.8
Israel	4.8	-3.1	-0.6	6.7	8.3	2.6	-2.5	9.1	12.6	5.4	6.0	6.6	6.7	5.6	1.1
Luxembourg	-0.3	2.3	0.7	8.5	5.4	6.7	8.4	3.3	8.6	-1.5	9.4	-0.4	3.1	1.8	4.2
Malta	-3.5	0.8	3.5	–	3.5	11.5	8.3	7.6	4.9	0.1	4.8	2.1	10.9	4.6	-3.7
Netherlands	2.0	1.8	3.7	3.8	1.4	1.8	4.7	3.5	1.9	1.6	-1.1	3.1	2.0	3.6	3.6
Norway	-0.1	4.6	5.5	7.2	-0.8	-3.1	-2.0	-0.3	0.8	1.7	3.2	4.4	3.9	4.7	5.6
Portugal	-5.5	-6.5	1.0	8.2	9.9	8.5	3.0	6.3	4.3	4.6	-1.0	1.5	1.5	2.1	5.3
Spain	0.5	-1.0	3.4	5.4	8.1	7.0	7.8	4.8	2.9	1.0	-4.2	1.3	3.2	1.4	2.7
Sweden	-1.3	3.2	4.2	2.1	4.3	2.8	3.7	0.8	-2.1	-1.8	-5.2	2.6	2.6	0.1	0.4
Switzerland	2.3	2.2	2.5	5.5	3.5	2.9	4.0	2.3	-0.6	-2.7	-1.0	2.5	2.3	-0.2	0.6
Turkey	5.8	6.4	3.2	7.0	8.9	-1.3	1.5	14.6	-0.9	5.9	14.2	-12.5	11.4	7.6	5.4
North America	5.0	7.5	4.3	3.4	2.9	3.1	2.8	0.8	-1.5	2.7	2.9	3.8	1.8	2.8	4.2
Canada	3.8	4.7	5.8	3.4	4.7	5.3	4.1	–	-1.4	0.9	1.5	3.0	1.0	1.1	5.3
United States	5.1	7.7	4.1	3.4	2.7	2.9	2.7	0.9	-1.6	2.8	3.0	3.9	1.8	3.0	4.1
Total above	3.3	4.7	3.4	3.8	3.5	3.8	3.2	2.1	-0.2	1.9	0.9	2.9	2.2	2.2	3.3
Memorandum item:															
Japan	1.7	3.2	3.8	3.9	5.1	7.4	5.6	5.2	2.9	0.4	0.1	1.0	2.3	4.8	-0.5
Total above, *including Japan*	3.0	4.5	3.5	3.8	3.7	4.3	3.6	2.6	0.3	1.7	0.7	2.6	2.2	2.6	2.7

Source: National statistics.

Note: See appendix table A.1.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.6

Real exports of goods and services in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	3.7	8.7	4.3	0.9	4.9	6.1	7.2	6.3	4.6	4.3	2.3	9.3	8.0	5.7	9.3
European Union[a]	3.3	8.0	4.4	1.2	4.0	5.5	7.6	6.6	4.8	4.0	2.1	9.2	8.2	4.9	9.0
4 major countries	1.8	7.5	4.9	0.6	3.1	4.9	8.4	7.4	4.7	3.5	1.3	8.3	8.0	4.2	8.8
France	3.7	7.0	1.9	-1.4	3.1	8.1	10.2	5.4	4.1	4.9	-0.4	6.0	6.3	5.2	12.1
Germany[b]	-0.8	8.2	7.6	-0.6	0.4	5.5	10.2	11.0	12.6	-0.3	-5.0	7.9	6.6	5.1	10.7
Italy	3.2	7.9	3.5	0.8	4.4	5.0	7.7	7.1	0.1	6.8	9.8	10.3	12.0	-0.6	6.5
United Kingdom	1.8	6.5	6.0	4.5	5.8	0.5	4.7	5.0	-0.7	4.1	3.5	9.6	7.8	6.8	4.9
17 smaller countries	7.5	11.2	3.2	1.5	8.3	8.2	4.9	4.3	4.4	5.8	4.4	11.3	7.9	8.6	10.3
Austria	3.6	6.3	7.1	-2.3	3.1	10.2	11.3	7.9	5.9	1.7	-1.3	5.6	6.5	9.3	6.8
Belgium	2.5	6.5	0.3	2.7	4.4	9.1	8.2	4.3	3.1	3.5	-0.7	9.5	6.8	3.2	5.9
Cyprus	8.2	15.1	-1.1	-1.7	13.7	13.5	16.8	7.9	-8.4	18.7	-1.5	7.8	4.2	3.5	0.2
Denmark	4.9	3.5	5.0	–	5.1	7.8	4.2	6.9	7.7	1.4	-0.8	8.2	5.3	4.1	4.5
Finland	2.0	5.0	1.1	1.2	2.7	3.7	1.3	1.4	-6.6	10.0	16.7	13.3	8.2	3.9	13.5
Greece	8.0	16.9	1.3	14.0	16.0	9.0	1.3	0.9	16.4	8.0	-4.7	7.7	1.0	0.2	5.2
Iceland	11.0	2.4	11.0	5.9	3.3	-3.6	2.9	–	-5.8	-1.7	6.6	9.8	-2.1	9.6	5.6
Ireland	10.5	16.6	6.6	2.9	13.7	9.0	10.3	8.7	5.3	13.5	9.7	14.2	19.6	10.0	17.7
Israel	1.7	13.6	10.0	5.9	10.4	-1.5	3.9	2.0	-2.0	14.9	10.7	12.4	8.3	5.0	6.1
Luxembourg	5.3	18.0	9.5	3.3	4.4	11.7	8.1	3.4	6.7	4.8	2.8	4.4	4.4	2.3	4.6
Malta	-1.8	4.0	7.4	7.0	12.6	6.1	10.7	13.3	7.5	9.7	5.3	7.1	5.4	-5.0	3.7
Netherlands	3.2	7.5	5.1	1.8	4.0	9.0	6.7	5.3	4.7	2.9	1.5	6.7	7.1	4.5	5.6
Norway	7.1	7.9	7.2	2.2	1.1	6.4	11.0	8.6	6.1	5.2	3.2	8.2	4.1	9.8	5.8
Portugal	13.6	11.6	6.7	6.8	11.2	6.5	13.0	10.1	1.0	4.1	-0.1	11.5	12.1	10.9	8.3
Spain	10.0	11.7	2.7	1.9	6.3	5.1	3.0	3.2	7.9	7.4	8.5	16.7	10.0	9.9	12.9
Sweden	9.9	6.9	1.2	3.7	4.3	2.5	3.1	1.6	-2.3	2.3	7.6	14.0	12.9	6.1	12.8
Switzerland	1.1	6.3	8.3	0.4	1.7	5.8	5.0	3.0	-2.1	3.0	1.5	2.1	1.3	2.5	8.1
Turkey	13.1	25.4	-1.9	-5.1	26.4	18.4	-0.3	3.1	3.1	11.0	7.7	15.2	8.0	22.0	17.5
North America	-1.9	9.1	2.9	7.2	10.4	15.4	10.8	8.2	6.0	6.7	3.7	8.5	10.9	8.1	12.0
Canada	6.4	18.6	5.5	5.2	3.3	9.5	1.3	4.7	2.3	7.9	12.0	11.8	9.3	5.7	8.0
United States	-2.6	8.3	2.7	7.4	11.0	15.9	11.7	8.5	6.3	6.6	2.9	8.2	11.1	8.3	12.3
Total above	0.9	8.9	3.6	4.1	7.7	10.7	9.0	7.3	5.3	5.5	3.0	8.9	9.4	6.9	10.7
Memorandum item:															
Japan	4.8	14.8	5.4	-5.7	-0.5	5.9	9.1	6.9	5.2	5.0	1.3	4.6	5.4	3.5	11.0
Total above, *including Japan*	1.5	9.9	3.9	2.5	6.4	10.0	9.1	7.2	5.3	5.4	2.7	8.2	8.8	6.4	10.7

Source: National statistics.

Note: See appendix table A.1.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.7

Real imports of goods and services in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	1.5	6.6	4.4	5.5	9.2	7.8	8.7	7.7	3.9	4.2	-1.8	6.4	8.2	4.5	8.4
European Union[a]	0.7	5.9	4.8	5.8	8.8	8.6	9.0	6.7	4.5	4.2	-3.7	7.7	7.3	3.7	8.2
4 major countries	0.5	7.2	4.2	5.1	7.7	7.8	8.2	6.9	4.4	4.0	-4.1	6.9	6.6	3.0	8.0
France	-2.7	2.7	4.5	7.1	7.7	8.6	8.1	6.1	3.0	1.2	-3.5	6.7	5.1	3.0	7.7
Germany[b]	1.4	5.2	4.5	2.7	4.2	5.1	8.3	10.3	13.1	2.0	-5.9	7.7	7.3	2.8	7.0
Italy	-2.9	12.2	5.0	4.3	12.0	6.1	9.0	9.4	3.3	7.4	-8.8	6.8	9.6	-1.7	11.9
United Kingdom	6.6	9.9	2.6	6.9	7.8	12.6	7.4	0.5	-5.2	6.6	3.0	5.8	4.2	8.4	5.6
17 smaller countries	3.3	5.3	4.7	6.3	12.2	7.7	9.7	9.2	2.9	4.6	2.8	5.6	11.2	7.4	9.1
Austria	5.7	10.0	6.2	-2.9	5.4	10.4	8.4	7.3	6.5	1.8	-0.7	8.3	7.0	8.7	6.4
Belgium	-1.3	6.3	0.2	4.5	6.1	9.7	9.4	4.9	2.8	4.1	-0.7	8.2	6.1	2.8	5.1
Cyprus	5.5	16.4	-4.5	-11.0	5.5	13.4	20.4	5.8	2.2	18.2	-18.5	8.7	11.5	5.6	-4.5
Denmark	1.8	5.5	8.1	6.8	-2.0	1.5	4.5	1.2	4.1	0.8	-3.0	12.9	9.8	3.7	7.0
Finland	3.1	1.6	6.4	2.6	9.2	11.1	8.9	-0.6	-11.7	1.1	0.8	12.8	6.9	4.3	9.3
Greece	6.6	0.2	12.8	3.8	16.6	8.0	10.8	10.8	13.0	6.5	-1.3	4.1	6.1	3.9	5.9
Iceland	-9.7	9.2	9.4	1.0	23.3	-4.6	-10.3	1.0	5.5	-7.8	-8.6	4.1	3.8	16.6	8.0
Ireland	4.7	9.9	3.2	5.6	6.2	4.9	13.5	5.1	2.3	7.9	7.2	14.8	15.8	11.4	16.0
Israel	6.8	-1.1	-0.9	9.2	19.0	-2.9	-4.9	9.1	15.5	9.0	14.2	10.9	8.4	7.6	2.6
Luxembourg	1.2	13.9	7.0	3.8	7.5	8.2	6.6	4.5	9.0	-0.8	2.8	-0.1	3.8	1.0	5.2
Malta	-7.2	3.9	9.2	0.1	12.3	11.1	11.1	15.7	5.4	3.0	5.9	7.5	10.0	-4.9	-6.1
Netherlands	3.9	5.0	6.3	3.5	4.2	7.6	6.7	4.2	4.1	2.1	-2.1	6.7	7.2	5.3	6.3
Norway	-3.1	5.8	8.9	11.8	-6.5	-2.4	2.2	2.5	0.2	0.7	4.4	6.9	3.5	8.3	12.3
Portugal	-6.1	-4.4	1.4	16.9	23.1	17.3	5.8	14.1	6.4	10.5	-3.0	10.9	8.8	7.4	11.0
Spain	-0.3	-1.8	7.9	14.4	20.1	14.4	17.3	7.8	9.0	6.9	-5.2	11.3	11.0	6.2	10.1
Sweden	0.8	5.4	7.8	4.5	7.7	5.3	7.4	0.7	-4.9	1.1	-2.5	13.2	10.2	3.7	11.7
Switzerland	4.4	7.1	5.1	7.1	5.5	5.3	5.4	2.9	-1.6	-4.2	0.1	7.9	5.4	2.4	6.8
Turkey	16.9	19.7	-6.6	-3.5	23.0	-4.5	6.9	33.1	-5.3	10.9	35.8	-21.9	29.6	20.5	13.4
North America	12.5	23.8	6.7	8.4	6.1	4.8	4.1	3.7	-0.3	7.4	9.1	11.7	8.8	8.8	14.1
Canada	10.8	18.1	8.8	8.5	5.6	14.4	5.7	2.3	3.2	6.2	8.1	9.1	6.7	5.2	13.3
United States	12.6	24.3	6.5	8.4	6.1	3.9	3.9	3.9	-0.7	7.5	9.1	11.9	8.9	9.1	14.2
Total above	7.0	15.2	5.5	7.0	7.6	6.3	6.4	5.7	1.8	5.8	3.6	9.0	8.5	6.7	11.2
Memorandum item:															
Japan	-3.0	10.5	-1.4	1.9	9.5	20.9	18.6	7.9	-3.1	-0.7	-0.3	8.9	14.2	11.5	-0.1
Total above, *including Japan*	5.4	14.5	4.4	6.2	7.9	8.6	8.3	6.1	1.0	4.8	3.0	9.0	9.4	7.4	9.5

Source: National statistics.

Note: See appendix table A.1.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE A.8

Industrial output in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	1.2	2.7	3.8	2.5	2.5	4.5	4.1	2.4	–	-0.9	-2.6	4.5	4.0	0.5	4.1
European Union [a]	0.8	2.3	3.4	2.0	2.1	4.6	4.1	2.1	-0.1	-1.3	-3.2	4.9	3.6	0.1	3.8
4 major countries	0.2	1.9	3.6	2.0	1.9	4.9	3.8	2.0	0.1	-1.4	-3.4	4.6	3.0	-0.2	3.2
France	-0.7	0.3	2.1	0.6	1.2	4.6	3.7	1.5	-1.2	-1.2	-3.8	3.9	2.0	0.2	3.8
Germany [b]	0.6	3.0	4.9	1.8	0.5	3.5	4.9	5.3	3.5	-2.5	-7.2	3.5	2.1	0.4	4.0
Italy	-2.4	3.3	1.3	4.1	2.6	7.0	3.9	-0.7	-0.9	-1.3	-2.1	6.3	6.1	-2.9	2.8
United Kingdom	3.6	–	5.6	1.4	4.1	5.2	2.1	–	-3.3	0.4	2.2	5.3	2.1	1.2	1.4
13 smaller countries	3.4	4.5	4.3	3.6	4.1	3.6	4.6	3.3	-0.1	0.1	-0.6	4.1	6.3	2.2	6.3
Austria	1.1	5.2	4.6	1.1	1.0	4.4	6.5	6.8	1.9	-1.2	-1.5	4.0	4.9	1.2	6.2
Belgium	1.9	2.6	2.4	0.8	2.1	5.9	3.4	3.7	-2.0	–	-5.2	1.8	6.4	0.9	4.4
Finland	3.2	4.6	4.4	1.6	4.5	4.4	2.4	0.4	-9.0	1.3	5.4	11.4	8.1	3.3	8.9
Greece	-0.3	2.4	3.3	-0.4	-1.1	5.0	1.8	-2.4	-1.0	-1.0	-2.9	1.3	1.9	1.1	1.3
Ireland	7.9	10.0	3.3	2.2	8.9	10.7	11.6	4.7	3.3	9.1	5.6	11.9	18.8	8.0	15.3
Luxembourg	5.5	11.7	6.8	1.9	-0.6	8.6	7.8	-0.5	0.3	-0.8	-4.3	6.0	1.4	-1.9	7.0
Netherlands	1.8	5.0	4.8	0.2	1.1	0.1	5.1	2.4	1.7	-0.2	-1.2	4.3	2.0	4.2	2.0
Norway	8.8	6.3	17.9	3.0	6.6	2.9	9.3	2.5	2.5	5.7	3.6	7.0	6.0	5.4	3.4
Portugal	3.6	2.5	0.5	7.3	4.4	3.7	6.8	9.1	–	-2.3	-2.6	-0.2	4.6	1.4	2.5
Spain	2.6	0.8	1.8	3.3	4.6	3.1	5.0	-0.3	-0.7	-3.0	-4.7	7.4	4.8	-1.3	7.0
Sweden	4.5	5.7	2.9	0.1	2.8	2.9	3.0	0.2	-5.2	-1.1	0.5	11.9	11.7	2.3	7.4
Switzerland	-0.3	2.6	5.7	3.8	1.1	7.9	1.0	3.1	–	-1.0	-2.0	5.2	2.0	-1.0	5.8
Turkey	8.1	11.0	5.9	11.8	10.4	1.6	3.6	9.4	2.7	5.0	8.0	-6.2	12.6	7.6	11.2
North America	3.9	9.3	2.0	1.0	4.6	4.6	1.6	-0.4	-2.2	3.0	3.7	5.4	4.9	3.3	5.0
Canada	5.3	12.5	5.4	-0.6	4.4	6.1	-0.4	-2.8	-3.8	1.0	5.0	6.1	4.1	1.5	5.0
United States	3.7	9.0	1.7	1.1	4.7	4.5	1.8	-0.2	-2.0	3.2	3.6	5.3	5.0	3.5	5.0
Total above	2.4	5.6	3.0	1.8	3.5	4.5	3.0	1.1	-0.9	0.8	0.2	4.9	4.4	1.7	4.5
Memorandum item:															
Japan	3.2	9.4	3.6	-0.1	3.4	11.0	4.8	4.3	1.9	-5.8	-4.2	1.2	3.3	2.7	4.0
Total above, *including Japan*	2.6	6.4	3.1	1.4	3.5	5.8	3.3	1.8	-0.4	-0.5	-0.6	4.2	4.2	1.9	4.4

Source: National statistics; OECD, *Main Economic Indicators* (Paris), various issues.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from GDP originating in industry in 1990. Data were converted from national currency units into dollars using GDP purchasing power parities.

[a] 14 countries (excluding Denmark).

[b] West Germany 1983-1991.

APPENDIX TABLE A.9

Total employment in the ECE market economies, 1983-1997

(Percentage change over preceding year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	-0.2	0.4	0.9	1.1	1.3	1.6	1.7	1.6	0.4	-1.3	-1.7	–	1.0	0.5	–
European Union[a]	-0.4	0.2	0.7	0.9	1.1	1.6	1.7	1.6	–	-1.5	-2.0	-0.3	0.6	0.3	0.5
4 major countries	-0.6	0.6	0.7	0.7	0.9	1.5	1.6	1.5	–	-1.5	-1.8	-0.4	0.3	-0.2	–
France	-0.1	-0.9	-0.3	0.4	0.3	0.9	1.3	1.0	0.1	-0.7	-1.2	-0.1	1.0	0.2	0.2
Germany[b]	-1.4	0.2	0.7	1.4	0.7	0.8	1.5	3.0	2.5	-1.8	-1.7	-0.7	-0.4	-1.3	-1.4
Italy[c]	0.6	0.4	0.9	0.8	0.4	0.9	0.2	0.9	0.8	-1.0	-2.9	-1.4	-0.3	–	-0.2
United Kingdom[d]	-1.2	2.7	1.2	0.1	2.1	3.5	3.1	1.0	-3.2	-2.2	-1.5	0.7	1.1	0.8	1.9
17 smaller countries	0.3	0.1	1.2	1.6	1.8	1.6	1.9	1.7	0.9	-0.9	-1.5	0.7	2.1	1.5	–
Austria	-1.0	-0.1	0.3	0.3	-0.1	0.3	1.4	1.9	1.7	0.4	-0.5	0.1	0.2	-1.3	0.3
Belgium[d]	-1.0	-0.2	0.6	0.6	0.5	1.5	1.6	1.4	0.1	-0.4	-1.1	-0.7	0.3	0.4	0.3
Cyprus	2.5	3.8	3.7	1.1	3.1	4.7	3.9	2.8	0.6	4.1	-0.1	2.8	3.4	1.0	..
Denmark	0.3	1.7	2.5	2.6	0.8	-0.6	-0.6	-1.0	-1.5	-0.6	-1.0	-0.3	1.6	1.2	2.3
Finland	0.3	0.4	0.1	-0.4	0.5	0.6	0.7	-0.5	-5.2	-7.0	-6.5	-1.1	1.7	1.0	2.0
Greece	1.1	0.4	1.0	0.3	-0.1	1.7	0.4	1.3	-2.3	1.3	1.0	1.9	0.9	1.2	1.2
Iceland[c]	0.4	1.4	3.6	3.2	5.7	-3.0	-1.4	-0.9	-0.1	-1.4	-0.8	0.5	1.5	2.2	2.0
Ireland[e]	-1.9	-1.9	-2.2	0.2	-0.1	1.0	-0.1	3.3	0.7	1.0	0.6	3.1	5.1	3.9	3.2
Israel	3.2	1.5	0.7	1.4	2.6	3.5	0.5	2.1	6.1	4.2	6.1	6.9	5.2	2.4	1.4
Luxembourg	-0.3	0.6	1.4	2.6	2.8	3.1	2.7	4.1	4.1	2.5	1.8	2.5	2.5	2.6	3.6
Malta[f]	0.1	0.6	1.3	2.1	5.9	2.5	0.9	0.8	2.5	1.0	0.5	1.2	3.3	1.0	0.5
Netherlands[c]	-1.8	0.1	1.9	2.1	1.7	1.6	1.9	2.3	1.3	1.0	-0.1	-0.3	1.4	1.8	2.0
Norway	-0.3	0.6	2.7	3.0	2.1	-0.8	-2.8	-0.8	-0.8	-0.3	0.2	1.3	2.1	2.5	2.9
Portugal	4.7	-1.0	-0.5	2.7	2.3	2.2	1.9	1.7	2.7	-1.7	-2.0	-0.1	-0.6	0.6	1.9
Spain	-0.5	-2.7	1.1	2.2	3.1	2.9	4.0	2.6	0.2	-1.9	-4.3	-0.9	2.7	2.9	3.0
Sweden	0.2	0.8	1.0	0.6	0.8	1.4	1.5	0.9	-1.5	-4.4	-5.2	-1.0	1.5	-0.5	-1.0
Switzerland	–	1.0	2.0	2.3	2.5	2.6	2.7	3.2	1.8	-1.5	-0.8	-0.1	0.1	0.3	-0.3
Turkey	1.0	1.5	1.7	1.8	2.3	1.5	2.0	1.8	3.1	0.2	0.2	2.8	3.7	2.0	-2.5
North America	0.9	4.6	2.5	1.8	2.9	3.0	2.5	0.6	-0.8	-0.2	1.8	3.1	2.5	1.9	2.3
Canada	0.6	2.7	3.0	3.0	2.7	3.2	2.1	0.6	-1.9	-0.6	1.3	2.1	1.6	1.3	1.9
United States[g]	0.9	4.8	2.4	1.7	2.9	2.9	2.5	0.6	-0.7	-0.1	1.9	3.2	2.7	2.0	2.3
Total above	0.2	2.1	1.5	1.4	2.0	2.2	2.0	1.2	-0.1	-0.8	-0.2	1.3	1.7	1.1	1.0
Memorandum item:															
Japan	1.5	0.3	0.6	0.5	0.4	1.2	1.5	1.7	2.0	1.1	0.4	0.1	0.2	0.4	1.1
Total above, *including Japan*	0.5	1.8	1.4	1.2	1.7	2.0	1.9	1.3	0.3	-0.5	-0.1	1.1	1.4	1.0	1.0

Source: National statistics; OECD, *National Accounts Detailed Tables, Vol. II*, 1997 and *OECD Economic Outlook*, No. 63, June 1998 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel (and Cyprus in 1997). National accounts statistics, where available; otherwise annual labour force surveys. Unless otherwise indicated, the data refer to the number of persons employed, i.e. no adjustment is made for part-time workers. Comparisons with previous years are limited due to changes in methodology in Denmark (1994), Israel (1986 and 1996), Malta (1995) and Norway (1989).

[a] 15 countries.

[b] West Germany 1983-1991.

[c] Full-time equivalent data.

[d] June of each year.

[e] April of each year.

[f] End of year.

[g] Full-time equivalent employees plus the number of self-employed persons (unpaid family workers are not included).

APPENDIX TABLE A.10

Standardized unemployment rates [a] in the ECE market economies, 1983-1997

(Per cent of civilian labour force)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	8.9	9.3	9.4	9.4	9.3	8.8	8.1	7.6	8.0	8.9	10.2	10.6	10.1	10.1	9.8
European Union [b]	9.3	9.8	10.0	9.9	9.7	9.1	8.3	7.7	8.2	9.2	10.7	11.1	10.7	10.9	10.6
4 major countries	8.7	9.0	9.3	9.3	9.2	8.5	7.9	7.3	7.9	8.8	9.8	10.1	9.8	10.1	10.1
France	8.1	9.7	10.1	10.2	10.4	9.8	9.3	9.0	9.5	10.4	11.7	12.3	11.7	12.4	12.4
Germany [c]	7.7	7.1	7.1	6.4	6.2	6.2	5.6	4.8	5.6	6.6	7.9	8.4	8.2	8.9	9.7
Italy	7.7	8.1	8.4	9.2	9.9	10.0	10.0	9.1	8.8	9.0	10.3	11.4	11.9	12.0	12.1
United Kingdom	11.1	11.1	11.5	11.5	10.6	8.7	7.3	7.0	8.8	10.1	10.4	9.6	8.7	8.2	7.0
17 smaller countries	9.2	9.7	9.7	9.7	9.5	9.0	8.5	7.9	8.2	9.2	10.7	11.2	10.5	10.1	9.5
Austria	4.1	3.8	3.6	3.1	3.8	3.6	3.1	3.2	3.5	3.6	4.0	3.8	3.9	4.3	4.4
Belgium	11.1	11.1	10.4	10.3	10.0	8.9	7.5	6.7	6.6	7.3	8.9	10.0	9.9	9.7	9.2
Cyprus [d]	3.3	3.3	3.3	3.7	3.4	2.8	2.3	1.8	3.0	1.8	2.6	2.7	2.6	3.0	3.4
Denmark	10.4	10.1	9.0	7.8	7.8	6.1	7.4	7.7	8.5	9.2	10.1	8.2	7.2	6.8	5.5
Finland	5.4	5.9	6.0	6.7	4.9	4.4	3.3	3.2	7.2	12.4	16.9	17.4	16.2	15.3	14.0
Greece	7.9	8.1	7.8	7.4	7.4	7.7	7.5	6.4	7.0	7.9	8.6	8.9	9.2	9.6	9.6
Iceland	1.0	1.3	0.9	0.6	0.5	0.6	1.7	1.8	1.5	3.0	4.4	4.8	5.0	4.4	3.9
Ireland	14.0	15.5	16.9	16.8	16.6	16.1	14.7	13.4	14.8	15.4	15.6	14.3	12.3	11.6	10.1
Israel	4.5	5.9	6.7	7.1	6.1	6.4	8.9	9.6	10.6	11.2	10.0	7.8	6.9	6.7	7.7
Luxembourg	3.5	3.1	2.9	2.6	2.5	2.0	1.8	1.7	1.7	2.1	2.7	3.2	2.9	3.0	2.6
Malta [d]	8.5	8.6	8.1	6.9	4.4	4.0	3.7	3.8	3.6	4.0	4.5	4.0	3.6	3.7	4.4
Netherlands	9.7	9.3	8.3	8.3	8.0	7.5	6.9	6.2	5.8	5.6	6.6	7.1	6.9	6.3	5.2
Norway	3.5	3.2	2.6	2.0	2.1	3.3	5.0	5.3	5.6	6.0	6.1	5.5	5.0	4.9	4.2
Portugal	7.8	8.5	8.7	8.4	6.9	5.5	4.9	4.6	4.0	4.2	5.7	7.0	7.3	7.3	6.8
Spain	17.5	20.3	21.7	21.2	20.6	19.5	17.2	16.2	16.4	18.5	22.8	24.1	22.9	22.2	20.8
Sweden	3.7	3.3	2.9	2.7	2.2	1.8	1.6	1.7	3.1	5.6	9.1	9.4	8.8	9.6	9.9
Switzerland	0.9	1.0	0.8	0.7	0.7	0.6	0.5	0.5	1.1	2.5	4.5	4.7	4.2	4.7	5.2
Turkey	7.7	7.6	7.1	7.9	8.3	8.4	8.6	8.0	7.9	8.0	7.7	8.1	6.9	6.0	5.7
North America	9.8	7.9	7.5	7.3	6.5	5.7	5.5	5.9	7.2	7.9	7.3	6.5	6.0	5.8	5.3
Canada	11.9	11.3	10.5	9.6	8.8	7.8	7.5	8.1	10.4	11.3	11.2	10.4	9.5	9.7	9.2
United States	9.6	7.5	7.2	7.0	6.2	5.5	5.3	5.6	6.8	7.5	6.9	6.1	5.6	5.4	4.9
Total above	9.3	8.7	8.6	8.5	8.1	7.4	7.0	6.8	7.6	8.5	9.0	8.8	8.3	8.3	7.9
Memorandum item:															
Japan	2.7	2.7	2.6	2.8	2.8	2.5	2.3	2.1	2.1	2.2	2.5	2.9	3.1	3.4	3.4
Total above, *including Japan*	8.2	7.7	7.6	7.6	7.2	6.6	6.2	6.0	6.7	7.5	7.9	7.9	7.5	7.5	7.2

Source: National statistics; OECD, *Quarterly Labour Force Statistics,* No. 4, 1997, *Main Economic Indicators*, various issues and *OECD Economic Outlook*, No. 63, June 1998 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel. Comparisons with previous years are limited by changes in methodology in Austria (1994), Germany (1984), Israel (1985 and 1995), Italy (1993), Portugal (1992) and the United States (1990, 1994 and 1997).

[a] Adjusted to achieve comparability between countries except for Austria (1983-1992), Cyprus, Denmark (1983-1987), Finland (1983), Greece (1983-1989), Iceland, Israel, Malta, Switzerland and Turkey.

[b] 15 countries.

[c] West Germany 1983-1990.

[d] End of year.

APPENDIX TABLE A.11

Consumer prices in the ECE market economies, 1983-1997

(Percentage change over previous year)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Western Europe	8.1	6.8	5.9	3.5	3.2	3.6	5.0	5.5	5.0	4.3	3.5	2.8	3.0	2.4	2.0
European Union [a]	8.2	6.9	5.9	3.5	3.1	3.5	5.0	5.5	5.0	4.4	3.5	2.9	3.0	2.4	1.9
4 major countries	7.7	6.1	5.5	2.7	2.8	3.3	4.9	5.1	4.6	4.2	3.2	2.7	2.9	2.4	1.9
France	9.6	7.4	5.8	2.7	3.1	2.8	3.6	3.3	3.2	2.4	2.1	1.7	1.7	2.0	1.2
Germany [b]	3.3	2.4	2.0	-0.1	0.2	1.3	2.8	2.7	3.6	5.1	4.5	2.7	1.8	1.5	1.8
Italy	14.7	10.8	9.2	5.9	4.7	5.0	6.3	6.3	6.4	5.4	4.2	3.9	5.4	3.9	1.7
United Kingdom	4.6	5.0	6.1	3.4	4.1	4.9	7.8	9.5	5.9	3.7	1.6	2.4	3.5	2.4	3.2
16 smaller countries	9.0	8.4	6.8	5.2	4.0	4.2	5.3	6.3	5.8	4.6	4.1	3.1	3.1	2.5	1.8
Austria	3.3	5.6	3.2	1.7	1.4	2.0	2.5	3.2	3.4	4.0	3.7	3.0	2.2	1.9	1.3
Belgium	7.7	6.3	4.9	1.3	1.6	1.3	3.0	3.4	3.2	2.4	2.8	2.4	1.5	2.0	1.6
Cyprus	5.1	6.0	5.1	1.2	2.8	3.4	3.8	4.5	5.0	6.5	4.9	4.7	2.6	2.9	3.6
Denmark	6.9	6.3	4.7	3.6	4.0	4.6	4.8	2.7	2.4	2.1	1.3	2.0	2.1	2.0	2.2
Finland	8.3	7.1	5.9	2.9	4.1	5.1	6.6	6.2	4.3	3.0	2.1	1.1	1.0	0.5	1.2
Greece	20.2	18.5	19.3	23.0	16.4	13.5	13.7	20.5	19.5	15.8	14.4	10.9	8.8	8.3	5.5
Iceland	84.3	29.2	32.6	22.7	18.8	25.8	20.8	15.4	6.8	3.7	4.1	1.5	1.7	2.3	1.6
Ireland	10.5	8.6	5.4	3.9	3.2	2.1	4.0	3.4	3.2	3.0	1.5	2.4	2.5	1.6	1.5
Israel	145.7	373.8	304.6	48.1	19.9	16.3	20.2	17.2	19.0	12.0	11.0	12.3	10.1	11.3	9.0
Luxembourg	8.7	5.6	4.1	0.3	-0.1	1.5	3.3	3.7	3.1	3.2	3.6	2.2	2.0	1.4	1.3
Malta	-0.9	-0.4	-0.3	2.0	0.5	0.9	0.9	3.0	2.5	1.6	4.1	4.1	4.0	2.5	3.2
Netherlands	2.7	3.2	2.3	0.3	-0.8	0.7	1.1	2.5	3.1	3.2	2.6	2.7	2.0	2.1	2.2
Norway	8.4	6.2	5.7	7.2	8.7	6.7	4.6	4.1	3.4	2.3	2.3	1.4	2.4	1.3	2.6
Portugal	25.5	29.3	19.3	11.7	9.4	9.6	12.7	13.4	11.4	8.9	6.5	5.2	4.1	3.0	2.4
Spain	12.2	11.3	8.8	8.7	5.3	4.8	6.9	6.7	5.9	5.9	4.6	4.8	4.6	3.6	2.0
Sweden	9.0	8.0	7.4	4.2	4.2	5.8	6.5	10.5	9.3	2.2	4.7	2.2	2.5	0.5	0.5
Switzerland	3.0	3.0	3.4	0.7	1.5	1.8	3.2	5.4	5.9	4.0	3.3	0.9	1.8	0.8	0.5
Turkey	31.4	48.4	45.0	34.6	38.9	73.7	63.3	60.3	66.0	70.1	66.1	106.3	88.0	79.8	84.8
North America	3.4	4.3	3.6	2.1	3.7	4.1	4.8	5.3	4.3	2.9	2.9	2.4	2.8	2.8	2.2
Canada	5.7	4.4	3.9	4.2	4.4	4.0	5.0	4.8	5.6	1.5	1.8	0.2	2.1	1.6	1.6
United States	3.2	4.3	3.6	1.9	3.6	4.1	4.8	5.4	4.2	3.0	3.0	2.6	2.8	3.0	2.3
Total above	5.8	5.6	4.8	2.8	3.4	3.8	4.9	5.4	4.7	3.6	3.2	2.6	2.9	2.6	2.1
Memorandum item:															
Japan	1.8	2.3	2.0	0.6	0.1	0.7	2.2	3.1	3.2	1.7	1.3	0.7	-0.1	0.1	1.8
Total above, *including Japan*	5.1	5.0	4.3	2.4	2.8	3.3	4.4	5.0	4.4	3.3	2.9	2.3	2.4	2.2	2.0

Source: National statistics.

Note: All aggregates exclude Israel and Turkey.

[a] 15 countries.

[b] West Germany 1983-1991.

APPENDIX TABLE B.1

Real GDP/NMP in the transition countries, 1980, 1984-1997

(Indices, 1989=100)

	1980	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	89.4	93.1	94.6	97.7	99.2	100.7	100.0	92.5	82.3	78.2	77.7	81.0	85.9	89.4	92.0
Albania	79.4	86.6	88.2	93.1	92.4	91.0	100.0	90.0	64.8	60.1	65.9	71.4	80.9	88.2	82.1
Bosnia and Herzegovina	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Bulgaria	76.2	87.5	89.9	93.6	99.3	101.9	100.0	90.9	80.2	74.4	73.3	74.6	76.7	69.0	64.2
Croatia [a]	99.0	99.7	99.8	102.6	102.5	101.6	100.0	92.9	73.3	64.7	59.5	63.0	67.3	71.4	76.0
Czech Republic	..	..	91.3	93.2	93.7	95.7	100.0	98.8	87.4	84.5	85.0	87.3	92.9	96.5	97.5
Hungary	86.3	94.4	94.1	95.5	99.4	99.3	100.0	96.5	85.0	82.4	81.9	84.3	85.5	86.6	90.4
Poland	91.1	87.1	90.3	94.1	95.9	99.8	100.0	88.4	82.2	84.3	87.6	92.1	98.6	104.6	111.8
Romania	88.5	103.5	103.4	105.8	106.7	106.2	100.0	94.4	82.2	75.0	76.2	79.2	84.8	88.2	82.3
Slovakia	..	..	91.0	94.8	97.1	99.0	100.0	97.5	83.3	77.9	75.1	78.7	84.2	89.7	95.6
Slovenia	98.9	99.9	100.9	104.1	103.5	100.5	100.0	91.9	83.7	79.1	81.4	85.7	89.3	92.0	95.5
The former Yugoslav Republic of Macedonia	93.3	96.7	96.0	102.7	101.4	98.1	100.0	89.8	83.5	76.9	69.9	68.6	67.8	68.3	69.0
Yugoslavia [a]	95.7	98.4	98.7	101.4	100.2	98.8	100.0	92.1	81.4	58.7	40.6	41.7	44.2	46.8	50.3
Baltic states	68.6	82.1	82.0	86.1	88.6	95.7	100.0	97.5	89.6	67.9	58.3	55.4	56.7	59.1	63.5
Estonia	74.5	85.5	85.7	88.2	89.2	93.8	100.0	91.9	82.7	71.0	65.0	63.8	66.5	69.2	77.1
Latvia	70.1	82.8	82.6	86.4	87.7	93.1	100.0	102.7	92.0	59.9	51.0	51.4	50.9	52.6	56.1
Lithuania	64.7	80.1	79.8	84.9	88.9	98.4	100.0	96.7	91.2	71.8	60.2	54.3	56.1	58.7	62.1
CIS [b,c]	77.4	88.8	90.2	92.3	93.8	97.9	100.0	96.9	91.2	78.8	71.3	61.1	57.8	55.8	56.3
Armenia	73.5	90.5	95.9	97.7	94.5	92.2	100.0	94.5	83.4	48.6	44.3	46.7	49.9	52.8	54.4
Azerbaijan	79.6	95.8	98.8	100.6	105.1	109.7	100.0	88.3	87.7	67.9	52.2	41.9	37.0	37.4	39.6
Belarus	65.7	83.0	85.2	88.9	91.3	92.4	100.0	98.0	96.8	87.5	80.8	70.6	63.3	65.1	71.8
Georgia	79.4	95.7	100.0	98.8	96.8	103.6	100.0	84.9	67.0	36.9	26.1	23.4	24.0	26.1	29.0
Kazakhstan	87.0	89.6	90.8	92.3	92.1	100.1	100.0	99.0	88.1	83.4	75.8	66.2	60.8	61.1	62.3
Kyrgyzstan	69.1	84.0	82.9	83.6	84.7	95.6	100.0	104.8	96.6	83.2	70.3	56.2	53.2	56.9	62.9
Republic of Moldova	72.1	90.4	82.6	89.2	90.3	91.9	100.0	98.6	81.3	57.8	57.1	39.4	38.7	35.7	36.1
Russian Federation	78.1	89.0	90.7	92.9	94.2	98.4	100.0	97.0	92.2	78.8	72.0	62.8	60.2	58.1	58.6
Tajikistan	80.8	89.8	91.8	95.0	93.9	106.9	100.0	100.2	91.7	63.3	53.0	41.7	36.5	30.4	30.9
Turkmenistan	80.7	88.1	89.5	93.4	97.1	107.5	100.0	101.8	97.0	131.6	133.5	111.2	102.7	102.8	82.2*
Ukraine	75.0	88.4	88.7	90.0	93.4	95.2	100.0	96.4	88.0	79.3	68.0	52.5	46.1	41.5	40.2
Uzbekistan	76.0	84.9	88.1	88.0	88.4	97.0	100.0	99.2	98.7	87.8	85.8	81.3	80.6	81.9	86.2
Total above	80.6	89.8	91.3	93.7	95.2	98.6	100.0	95.7	88.6	78.3	72.8	66.7	65.9	65.6	66.9
Memorandum items:															
CETE-5	89.3	89.5	92.0	95.1	97.1	99.6	100.0	92.3	83.7	83.3	85.0	88.8	94.1	98.8	104.2
SETE-7	89.5	99.0	99.1	102.3	102.7	102.3	100.0	93.0	80.0	69.7	65.5	67.8	72.0	73.6	71.4
Czechoslovakia [b]	84.9	90.0	92.7	95.1	97.0	99.3	100.0	98.5	84.4	78.8	..	..	..	..	..
Yugoslavia (SFR) [a]	97.7	100.1	99.5	103.0	101.0	99.4	100.0	92.4	..	..	..	..	..	..	..
Former Soviet Union [b]	77.0	88.5	89.9	92.0	93.6	97.8	100.0	97.0	91.1	78.3	70.7	60.9	57.7	55.9	56.6
Ex-GDR Länder	..	..	..	..	..	..	100.0	84.5	68.3	73.6	80.4	88.2	92.8	94.5	96.0

Source: UN/ECE Common Database, derived from national and CIS statistics (IMF and World Bank data for Albania).

Note: Data for the east European countries are based on a GDP measure, except where otherwise mentioned. For the countries of the former Soviet Union, NMP data for 1980-1990 were chain-linked to GDP data from 1990. Country indices were aggregated with previous year weights (viz., previous year's GDP at 1992 prices).

[a] Gross material product (1980-1989 for Croatia).

[b] Sum of individual country data for former members.

[c] Net material product for 1980-1990 (until 1992 in the case of Turkmenistan).

APPENDIX TABLE B.2

Real total consumption expenditure in the transition countries, 1980, 1984-1997

(Indices, 1989=100 or earliest year available thereafter)

	1980	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Bulgaria	..	..	..	..	..	..	100.0	100.6	92.3	89.4	86.2	82.3	80.7	75.3	64.0
Croatia	..	..	..	..	..	..	..	..	100.0	87.2	85.3	92.0	106.6	109.2	..
Czech Republic	..	..	..	..	91.3	93.1	100.0	104.9	81.0	88.2	90.4	92.6	96.5	102.5	103.2
Hungary	92.2	97.3	99.2	101.5	104.9	102.0	100.0	97.3	92.2	92.8	97.9	95.6	89.3	86.2	..
Poland	108.0	101.9	105.1	109.3	111.8	114.7	100.0	88.3	94.9	98.2	103.0	107.0	110.7	119.0	126.4
Romania	83.9	86.0	85.4	85.8	88.7	90.6	100.0	108.9	96.0	90.7	91.8	95.3	105.5	113.9	106.6
Slovakia	..	..	81.8	85.4	89.2	92.1	100.0	103.3	76.9	75.6	74.3	71.6	73.9	82.0	85.5
Slovenia	..	..	..	..	..	..	..	100.0	91.6	88.8	99.1	102.4	110.1	..	..
Estonia	..	..	..	..	..	..	..	..	..	100.0	94.7	98.8	..	..	..
Latvia	..	..	..	..	..	..	..	100.0	76.7	49.2	46.5	47.4	47.0	50.8	52.7
Azerbaijan	..	..	..	..	..	..	..	..	..	100.0	77.5	62.2	60.5	..	..
Belarus	..	..	..	..	..	..	..	100.0	93.4	84.0	82.1	72.1	65.3	67.4	..
Kazakhstan	..	..	..	..	..	..	..	100.0	104.4	103.8	92.3	71.8	58.4	57.9	..
Kyrgyzstan	..	..	..	..	..	..	..	100.0	83.5	72.8	64.3	51.4	43.8	..	..
Republic of Moldova	..	..	..	..	..	..	..	..	100.0	67.7	66.6	38.5	..	..	..
Russian Federation	..	..	..	..	..	..	..	100.0	93.9	89.0	88.1	85.4	83.1	79.4	..
Ukraine	..	..	..	..	..	..	..	100.0	94.3	88.6	72.0	65.0	62.6	..	..

Source: UN/ECE Common Database, derived from national and CIS statistics.

APPENDIX TABLE B.3

Real gross fixed capital formation in the transition countries, 1980, 1984-1997

(Indices, 1989=100 or earliest year available thereafter)

	1980	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Bulgaria	..	..	..	..	..	..	100.0	100.0	80.0	74.1	61.2	61.9	71.8	56.6	44.1
Croatia	..	..	..	..	..	..	..	..	100.0	88.5	94.5	93.6	108.2	..	..
Czech Republic	..	..	..	..	93.4	99.4	100.0	97.9	80.5	87.7	81.0	95.0	114.9	124.9	118.8
Hungary	114.7	100.5	94.6	100.8	110.7	100.6	100.0	92.9	83.1	81.0	82.6	92.9	88.9	94.4	..
Poland	124.6	104.9	111.4	116.4	116.5	126.5	100.0	75.2	71.9	73.6	75.7	82.6	96.6	116.5	142.0
Romania	163.7	158.9	161.5	163.3	161.0	157.6	100.0	64.4	44.0	48.9	52.9	63.9	68.3	71.0	59.7
Slovakia	..	..	..	..	..	..	..	100.0	74.8	71.5	68.5	64.7	64.6	90.3	103.3
Slovenia	..	..	..	..	..	..	..	100.0	88.5	77.1	85.4	96.0	112.5	..	..
Estonia	..	..	..	..	..	..	..	..	..	100.0	110.0	121.1	..	..	..
Latvia	..	..	..	..	..	..	..	100.0	36.1	25.7	21.6	21.8	23.7	29.0	..
Azerbaijan	..	..	..	..	..	..	..	..	..	100.0	61.0	31.7	8.9	..	..
Belarus	..	..	..	..	..	..	..	100.0	105.3	85.6	79.1	68.3	48.1	46.6	..
Kazakhstan	..	..	..	..	..	..	..	100.0	74.2	61.9	61.5	48.5	34.7	21.5	..
Kyrgyzstan	..	..	..	..	..	..	..	100.0	88.7	62.8	49.1	34.9	59.6	..	..
Republic of Moldova	..	..	..	..	..	..	..	..	100.0	69.1	40.6	9.5	..	..	..
Russian Federation	..	..	..	..	..	..	..	100.0	84.5	49.4	36.7	27.1	25.1	20.5	..
Ukraine	..	..	..	..	..	..	..	100.0	81.6	69.4	48.2	28.4	19.7	..	..

Source: UN/ECE Common Database, derived from national and CIS statistics.

APPENDIX TABLE B.4

Real gross industrial output in the transition countries, 1980, 1984-1997

(Indices, 1989=100)

	1980	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	83.1	89.0	91.6	95.5	98.0	100.6	100.0	83.9	66.5	60.5	59.6	64.1	69.0	73.5	77.6
Albania	77.0	88.5	87.5	91.9	93.3	95.2	100.0	86.7	50.4	35.2	31.7	25.8	23.9	27.2	25.7
Bosnia and Herzegovina	106.0	104.1	104.1	104.1	101.1	98.1	100.0	88.7	74.3	..	..	..	..	..	..
Bulgaria	71.3	85.5	88.3	92.4	98.0	101.1	100.0	83.2	66.4	54.2	48.8	54.0	56.4	58.6	54.5
Croatia	88.7	93.1	95.1	99.4	102.0	100.6	100.0	88.7	63.4	54.2	50.9	49.6	49.8	51.3	54.8
Czech Republic	81.5	89.0	92.0	94.5	96.5	98.5	100.0	96.5	73.0	67.2	63.6	65.0	70.6	| 72.0	75.3
Hungary	92.9	101.4	102.1	104.0	106.4	105.3	100.0	90.7	74.1	66.9	69.6	76.2	79.7	| 82.4	91.5
Poland	86.3	84.4	88.5	92.3	95.5	100.5	100.0	75.8	66.8	69.4	73.8	82.8	90.8	98.3	109.0
Romania	76.9	89.1	90.5	96.8	99.2	101.9	100.0	81.9	63.3	49.4	50.1	51.7	56.6	62.2	58.5
Slovakia	76.7	87.4	91.6	95.2	98.6	100.8	100.0	96.0	77.4	70.3	67.6	70.9	76.8	78.7	80.8
Slovenia	90.3	99.7	101.0	102.7	101.6	98.9	100.0	89.5	78.4	68.1	66.1	70.4	71.8	72.5	73.2
The former Yugoslav Republic of Macedonia	72.1	85.9	88.6	95.0	97.3	95.6	100.0	89.3	73.8	62.3	53.5	47.9	42.8	44.1	44.8
Yugoslavia	80.0	91.2	93.6	96.8	97.6	98.4	100.0	87.2	71.9	56.5	35.4	35.9	37.2	40.0	43.8
Baltic states	72.6	82.7	85.5	89.4	93.1	96.9	100.0	99.0	95.7	64.5	44.8	37.6	38.1	40.0	42.2
Estonia	78.5	87.9	90.2	93.5	96.3	99.3	100.0	100.0	92.8	59.8	48.6	47.1	48.0	49.7	56.3
Latvia	72.5	83.5	86.6	89.9	93.7	97.1	100.0	100.8	100.2	65.6	44.6	40.1	38.7	40.8	43.3
Lithuania	70.0	79.8	82.6	87.2	91.2	95.6	100.0	97.4	94.0	65.8	43.2	31.7	33.4	35.1	35.2
CIS [a]	73.0	84.1	87.2	91.0	94.4	98.1	100.0	99.9	93.7	79.1	69.9	54.9	51.7	50.2	51.4
Armenia	76.3	95.4	100.7	105.3	110.3	109.1	100.0	92.5	85.4	44.2	39.7	41.8	42.4	42.9	43.3
Azerbaijan	76.1	94.1	94.5	92.7	96.1	99.3	100.0	93.7	98.2	74.9	69.7	53.9	44.6	41.6	41.7
Belarus	61.1	74.5	79.0	84.3	89.9	95.6	100.0	102.1	101.1	91.6	82.4	68.3	60.3	62.4	73.4
Georgia	70.6	86.1	91.8	93.9	96.2	99.3	100.0	94.3	73.0	39.6	29.0	17.5	15.8	17.0	18.4
Kazakhstan	72.4	82.8	85.8	90.2	94.1	97.6	100.0	99.2	98.3	84.7	72.2	51.9	47.7	47.8	49.7
Kyrgyzstan	66.7	80.8	84.2	87.8	89.0	95.1	100.0	99.4	99.1	72.9	54.5	39.2	32.2	35.1	51.5
Republic of Moldova [b]	68.7	87.3	85.1	87.3	91.6	94.6	100.0	103.2	91.7	66.9	67.1	48.5	46.6	43.6	42.6
Russian Federation	74.4	84.9	87.8	91.8	95.0	98.6	100.0	99.9	91.9	75.4	64.7	51.2	49.5	47.5	48.4
Tajikistan	72.9	84.7	87.1	88.7	93.1	98.2	100.0	101.2	97.6	73.9	68.1	50.8	43.9	33.4	32.6
Turkmenistan	75.4	84.2	86.0	90.1	92.9	96.9	100.0	103.2	108.2	92.0	95.7	72.1	67.5	79.5	51.7*
Ukraine	72.6	83.5	86.4	90.0	93.4	97.3	100.0	99.9	95.1	89.0	81.9	59.5	52.4	49.7	48.8
Uzbekistan	68.5	80.4	86.0	91.2	93.4	96.5	100.0	101.8	103.3	96.4	99.9	101.5	101.6	107.7	114.7
Total above	75.7	85.3	88.3	92.2	95.3	98.7	100.0	95.7	86.6	73.8	66.4	56.8	55.8	56.0	58.0
Memorandum items:															
CETE-5	85.8	88.2	91.5	94.8	97.4	100.6	100.0	83.4	70.2	68.8	70.8	77.4	84.0	89.2	97.1
SETE-7	79.3	90.1	91.8	96.6	98.9	100.5	100.0	84.5	61.3	48.8	43.8	45.1	47.7	51.3	50.0
Czechoslovakia	80.5	88.8	91.9	94.8	97.2	99.2	100.0	96.5	75.2	67.6	..	..	..	..	..
Yugoslavia (SFR) [a]	86.9	94.6	96.4	99.3	99.7	98.7	100.0	88.3	71.7	..	..	..	..	..	..
Former Soviet Union	73.0	84.0	87.1	91.0	94.4	98.1	100.0	99.9	93.7	78.5	68.8	54.2	51.1	49.8	51.0
Ex-GDR Länder	75.2	85.7	89.5	92.5	94.7	97.7	100.0	72.7	37.0	34.8	36.8	42.0	44.4	46.3	48.6*

Source: UN/ECE Common Database, derived from national and CIS statistics (IMF and World Bank data for Albania).

Note: Data for former Czechoslovakia and SFR of Yugoslavia for 1980 to the breakup obtained as sum of individual country data for former members. For the countries of the former Soviet Union, data for 1980-1990 were chain-linked to national or CIS data from 1990. Country indices were aggregated with previous year gross industrial output weights.

[a] Generated from components.

[b] Excluding Transnistria since 1993.

APPENDIX TABLE B.5

Total employment in the transition countries, 1980, 1984-1997

(Indices, 1989=100)

	1980	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	96.7	97.6	98.6	99.4	100.0	99.9	100.0	97.1	91.5	86.9	84.3	84.4	83.9	84.3	..
Albania	77.9	87.7	90.1	93.1	95.9	97.6	100.0	99.2	97.5	76.0	72.7	80.7	79.0	77.5	76.9
Bulgaria	100.0	102.1	102.2	102.5	102.8	102.4	100.0	93.9	81.6	75.0	73.8	74.3	75.2	75.3	..
Croatia	87.4	93.8	95.9	98.6	100.6	100.4	100.0	97.1	89.2	79.3	76.6	74.8	73.9	74.5	71.9
Czech Republic	95.3	95.7	97.5	98.5	98.9	99.4	100.0	99.1	93.6	91.2	89.7	90.4	92.8	93.4	92.4
Hungary [a]	104.2	102.2	102.0	102.1	101.4	100.6	100.0	96.9	87.7	79.5	75.6	73.9	72.6	72.6	..
Poland	102.0	100.0	100.8	101.1	100.8	100.1	100.0	95.8	90.1	86.3	84.3	85.1	86.7	88.3	..
Romania [a]	94.6	95.9	96.7	97.5	97.9	98.7	100.0	99.0	98.5	95.5	91.9	91.5	86.7	85.7	..
Slovakia [a]	91.3	95.5	96.8	98.4	99.4	100.2	100.0	98.2	85.9	86.8	84.6	83.7	85.7	87.7	..
Slovenia [b]	84.0	87.6	88.9	90.4	101.9	101.3	100.0	96.1	88.7	83.8	81.3	79.3	79.1	78.7	78.6
The former Yugoslav Republic of Macedonia	79.1	90.4	92.7	96.0	100.5	100.1	100.0	98.5	95.6	91.2	86.2	81.7	73.9	70.6	66.8
Yugoslavia	83.4	91.4	93.7	96.5	99.0	99.8	100.0	97.0	94.1	90.9	88.3	86.5	85.3	84.8	83.6
Baltic states [c]	94.9	97.6	98.0	98.8	99.4	99.6	100.0	98.5	98.9	94.4	89.0	83.2	80.6	80.1	..
Estonia	..	..	96.7	97.9	97.6	97.6	100.0	98.6	96.4	91.4	84.5	82.7	78.3	77.0	..
Latvia	97.0	98.8	99.1	99.8	100.4	100.5	100.0	100.1	99.3	92.0	85.6	77.0	74.3	72.3	73.7
Lithuania	93.4	96.8	97.7	98.5	99.5	99.8	100.0	97.3	99.7	97.5	93.4	88.0	86.4	87.2	87.7
CIS	94.3	97.2	97.8	98.3	98.9	99.3	100.0	100.2	98.9	96.5	94.1	91.3	90.4	89.6	88.7
Armenia	86.6	94.3	97.2	98.6	99.5	101.4	100.0	102.4	105.0	99.2	97.0	93.5	92.8	90.2	88.6
Azerbaijan	79.8	88.8	90.9	92.7	95.2	95.8	100.0	100.9	105.8	101.4	101.2	99.0	98.5	100.5	100.7
Belarus	95.4	98.0	98.4	98.8	99.0	99.5	100.0	99.1	96.6	94.1	92.9	90.4	84.8	84.0	84.1
Georgia	92.7	97.2	98.8	100.1	101.0	101.1	100.0	102.3	93.3	73.5	66.4	64.8	79.0	79.1	77.8
Kazakhstan	86.2	91.7	92.6	93.5	94.7	96.0	100.0	101.3	100.1	98.3	89.9	85.4	85.0	84.6	83.1
Kyrgyzstan	81.9	90.9	92.8	95.0	97.9	98.7	100.0	100.5	99.6	105.6	96.6	94.6	94.4	95.0	96.6
Republic of Moldova [d]	97.3	99.2	99.5	99.6	99.7	98.9	100.0	99.1	99.0	98.0	80.7	80.4	80.0	79.4	78.7
Russian Federation	96.9	98.7	99.1	99.5	99.7	99.9	100.0	99.6	97.7	95.3	93.7	90.6	87.9	87.2	86.5
Tajikistan	76.7	86.5	89.5	91.2	94.5	96.9	100.0	103.2	104.9	101.6	98.7	98.7	98.6	92.1	94.8
Turkmenistan	76.4	87.9	89.7	91.7	94.3	96.8	100.0	103.4	105.3	105.4	110.0	111.6	112.1	111.7	114.0
Ukraine	99.6	100.6	100.6	100.5	100.3	99.9	100.0	99.9	98.3	96.3	94.1	90.5	93.3	91.3	88.5
Uzbekistan	75.4	85.2	86.8	88.9	93.2	95.9	100.0	104.2	109.2	108.5	108.3	109.9	110.8	112.3	113.8
Total above	94.6	96.9	98.0	98.6	99.2	99.5	100.0	99.3	96.9	93.8	91.3	89.2	88.4	88.0	..
Memorandum items:															
CETE-5	99.8	98.9	99.8	100.3	100.5	100.1	100.0	96.7	89.9	85.9	83.6	83.8	85.0	86.1	18.3
SETE-7	92.2	95.7	96.8	98.1	99.2	99.7	100.0	97.6	93.7	88.2	85.3	85.2	82.4	81.7	..
Former Soviet Union	93.7	96.6	97.8	98.3	98.9	99.3	100.0	100.2	98.9	96.4	94.0	91.1	90.1	89.3	88.0

Source: UN/ECE Common Database, derived from national and CIS statistics.

[a] End of year.

[b] Self-employed excluded until 1987.

[c] Excluding Estonia until 1985.

[d] Excluding Transnistria since 1993.

APPENDIX TABLE B.6

Registered unemployment in the transition countries, 1990, 1993-1997

(Thousands and per cent of labour force, end of period)

	Thousands						*Per cent of labour force*					
	1990	*1993*	*1994*	*1995*	*1996*	*1997*	*1990*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	2 773	7 443	7 190	6 583	6 115	5 974	..	14.0	13.6	12.5	11.8	11.7
Albania	150	301	262	171	158	194	9.5	22.0	18.0	13.1	12.1	14.9
Bosnia and Herzegovina	..	..	..	..	..	..	..	..	..	..	..	..
Bulgaria	72	626	488	424	478	524	1.8	16.4	12.8	11.1	12.5	13.7
Croatia	196	243	248	249	269	287	..	16.6	17.3	17.6	15.9	17.6
Czech Republic	39	185	167	153	186	269	0.7	3.5	3.2	2.9	3.5	5.2
Hungary	101	632	520	496	479	464	1.7	12.1	10.9	10.4	10.5	10.4
Poland	1 126	2 890	2 838	2 629	2 360	1 826	6.5	16.4	16.0	14.9	13.2	10.5
Romania	150	1 165	1 224	998	658	881	1.3	10.4	10.9	9.5	6.3	8.8
Slovakia	40	368	372	330	330	348	1.6	14.4	14.8	13.1	12.8	12.5
Slovenia	55	137	124	127	125	129	..	15.5	14.2	14.5	14.4	14.8
The former Yugoslav Republic of Macedonia [a]	156	177	196	229	245	258	..	30.3	33.2	37.2	39.8	42.5
Yugoslavia [a]	688	718	751	777	827	794	..	24.0	23.9	24.7	26.1	25.6
Baltic states	..	176	197	245	237	236	..	4.5	5.3	6.5	6.4	6.3
Estonia [b]	..	34	35	34	37	31	..	5.0	5.1	5.0	5.6	4.6
Latvia	..	77	84	83	91	85	..	5.8	6.5	6.6	7.2	6.7
Lithuania	..	65	78	128	109	120	..	3.4	4.5	7.3	6.2	6.7
CIS	..	4 524	6 011	7 185	8 027	7 852	..	3.6	4.4	5.8	6.2	6.2
Armenia	..	103	92	132	159	174	..	6.3	6.0	8.1	9.7	11.0
Azerbaijan	..	20	24	28	32	38	..	0.7	0.9	1.1	1.1	1.3
Belarus	..	66	101	131	183	126	..	1.3	2.1	2.7	4	2.8
Georgia	..	40	76	61	58	55	..	2.0	3.8	3.4	3.2	2.6
Kazakhstan	..	41	70	140	282	259	..	0.6	1.0	2.1	4.1	3.9
Kyrgyzstan	..	3	13	50	77	55	..	0.2	0.8	3.0	4.5	3.1
Republic of Moldova	..	14	21	25	23	28	..	0.7	1.0	1.4	1.5	1.7
Russian Federation [c]	..	4 120	5 478	6 431	6 788	6 400	..	5.5	7.5	8.9	9.3	9.0
Tajikistan	..	22	32	35	46	51	..	1.1	1.8	1.8	2.4	2.8
Turkmenistan	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine	..	84	82	127	351	637	..	0.4	0.3	0.6	1.5	2.8
Uzbekistan	..	13	22	25	28	29	..	0.2	0.3	0.3	0.3	0.3
Total above	..	12 143	13 398	14 013	14 379	14 060	..	6.6	6.9	7.5	7.8	7.8
Memorandum items:												
CETE-5	1 361	4 212	4 021	3 735	3 480	3 036	..	13.3	12.9	12.0	11.3	9.9
SETE-7	1 412	3 230	3 169	2 848	2 635	2 936	..	15.1	14.6	13.7	12.5	14.2
Russian Federation [d]	..	836	1 637	2 327	2 506	2 005	..	1.1	2.1	3.2	3.4	2.8

Source: National statistics and direct communications from national statistical offices to UN/ECE secretariat.

[a] The data reported on employment cover only the social sector in agriculture, hence unemployment rates are biased upwards. In Yugoslavia, according to the labour force survey, the unemployment rate was 13.2 per cent in May 1996, instead of the officially reported rate of some 26 per cent. Also, in The former Yugoslav Republic of Macedonia, according to the labour force survey, the unemployment rate was some 32 per cent in April 1996 instead of the officially reported rate of 38 per cent.

[b] Job seekers.

[c] Based on Russian Federation Goskomstat's monthly estimates according to the ILO definition, i.e. including all persons not having employment but actively seeking work.

[d] Registered unemployment.

APPENDIX TABLE B.7

Consumer prices in the transition countries, 1989-1997

(Annual average, percentage change over preceding year)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Albania	..	..	35.5	193.1	85.0	21.5	8.0	12.7	33.1
Bosnia and Herzegovina	36.8	594.0	116.2	64 218.3	38 825.1	553.5	-12.1	-21.2	11.8
Bulgaria	6.4	23.8	338.5	91.3	72.9	96.2	62.1	123.1	1 082.6
Croatia[a]	1 200.0	609.5	123.0	663.6	1 516.6	97.5	2.0	3.6	3.7
Czech Republic	1.4	9.9	56.7	11.1	20.8	10.0	9.1	8.9	8.4
Hungary	17.0	28.9	35.0	23.0	22.6	19.1	28.5	23.6	18.4
Poland	264.3	585.8	59.4	45.3	36.9	33.2	28.1	19.8	15.1
Romania	1.1	5.1	170.2	210.7	256.2	137.1	32.2	38.8	154.9
Slovakia	1.3	10.4	61.2	10.2	23.1	13.4	10.0	6.0	6.2
Slovenia[a]	1 285.3	551.6	115.0	207.3	31.7	21.0	13.5	9.9	8.4
The former Yugoslav Republic of Macedonia[a]	1 246.0	608.4	114.9	1 505.5	353.1	121.0	16.9	4.1	3.6
Yugoslavia	1 265.0	580.0	122.0	8 926.0	2.2E+14	7.9E+10	71.8	90.5	23.2
Estonia	4.0	18.0	202.0	1 078.2	89.6	47.9	28.9	23.1	11.1
Latvia	5.2	10.9	172.2	951.2	109.1	35.7	25.0	17.7	8.5
Lithuania	2.1	9.1	216.4	1 020.5	410.1	72.0	39.5	24.7	8.8
Armenia	0.8	6.9	174.1	728.7	3 731.8	4 964.0	175.5	18.7	13.8
Azerbaijan	0.5	6.1	106.6	912.6	1 129.7	1 663.9	411.5	19.8	3.6
Belarus	1.7	5.5	98.6	971.2	1 190.9	2 219.6	709.3	52.7	63.9
Georgia	0.9	4.2	78.7	1 176.9	4 084.9	22 470.6	177.6	39.4	6.9
Kazakhstan	1.8	5.6	114.5	1 504.3	1 662.7	1 879.5	175.9	39.1	17.4
Kyrgyzstan	1.6	5.5	113.9	854.6	1 208.7	278.1	42.9	30.3	25.5
Republic of Moldova	1.1	5.7	114.4	1 308.0	1 751.0	486.4	29.9	23.5	11.8
Russian Federation	2.5	5.3	100.3	1 528.7	875.0	309.0	197.4	47.8	14.7
Tajikistan	1.7	5.9	112.9	822.0	2 884.8	350.3	682.1	422.4	85.4
Turkmenistan	2.5	5.7	112.4	769.9	1 630.5	2 714.0	..	..	..
Ukraine	2.0	5.4	94.0	1 209.6	4 734.9	891.2	376.7	80.2	15.9
Uzbekistan	0.7	5.8	97.3	414.5	1 231.8	1 550.0	315.5	..	..

Source: UN/ECE Common Database, derived from national statistics.

Note: From 1992 onwards indices derived from monthly data. Retail prices for Bulgaria and CIS countries for 1989.

[a] Retail prices.

APPENDIX TABLE B.8

Producer price indices in the transition countries, 1989-1997

(Annual average, percentage change over preceding year)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Albania	..	..	..	..	..	..	..	..	..
Bosnia and Herzegovina	..	..	129.5	70 374.7	10 967.6	1 184.8	68.7	-4.8	3.2
Bulgaria	2.8	14.7	296.4	56.1	28.3	59.1	48.9	129.7	888.1
Croatia	1 346.7	455.3	146.3	826.0	1 510.4	77.7	0.8	1.3	2.4
Czech Republic	0.1	2.5	70.3	10.8	9.3	5.4	7.8	4.9	5.1
Hungary	15.4	22.0	32.6	12.3	14.1	12.3	28.5	22.3	20.9
Poland	212.8	622.4	40.9	28.0	32.6	31.0	26.0	13.4	12.2
Romania	..	26.9	220.1	184.8	165.0	140.7	35.3	50.0	156.7
Slovakia	..	..	68.9	5.3	17.2	10.0	9.1	4.0	4.6
Slovenia	1 413.3	390.4	124.1	215.7	23.3	17.8	12.4	6.7	6.1
The former Yugoslav Republic of Macedonia	1 357.0	393.8	112.0	2 193.5	258.6	88.7	4.7	-0.1	4.2
Yugoslavia	1 301.0	468.0	124.0	8 993.0	1.4E+13	7.9E+10	75.7	88.8	20.6
Estonia	..	19.3	208.4	1 208.0	75.2	36.1	25.5	14.7	8.8
Latvia	..	..	192.0	1 310.0	117.1	17.0	12.0	13.8	4.3
Lithuania	..	..	148.2	1 510.0	391.7	44.7	28.7	16.5	6.0
Armenia	..	..	120.0	947.0	892.0	4 394.4	187.8	36.3	21.7
Azerbaijan	..	..	135.0	1 303.0	1 040.7	3 971.6	1 340.1	70.6	11.4
Belarus	..	..	150.0	2 326.7	1 536.3	3 362.1	538.6	35.7	89.4
Georgia	..	..	..	..	..	..	..	..	..
Kazakhstan	..	..	193.0	2 369.0	1 342.0	2 952.2	173.6	24.8	15.6
Kyrgyzstan	..	..	160.0	1 664.0	831.0	223.6	34.0	44.7	33.7
Republic of Moldova	..	..	130.0	1 210.9	1 078.5	711.7	52.2	30.2	14.9
Russian Federation	..	..	138.0	1 949.0	887.0	340.0	237.6	50.7	15.0
Tajikistan	..	..	163.0	1 323.0	1 080.0	665.5	351.7	342.2	107.2
Turkmenistan	..	..	211.0	994.0	1 610.0	911.0	..	..	..
Ukraine	..	..	122.0	2 668.8	4 698.3	901.2	450.8	54.6	15.1
Uzbekistan	..	..	147.0	1 296.0	1 119.0	2 162.6	792.5	128.5	53.9

Source: UN/ECE Common Database, derived from national statistics.

Note: Indices derived from monthly data from 1992 onwards for east European countries and from 1994 for Baltic and CIS countries.

APPENDIX TABLE B.9

Nominal gross wages in industry in the transition countries, 1990-1997

(Annual average, percentage change over preceding year)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*[a]
Albania[b]	..	..	..	69.5	34.5	29.3	..	..
Bosnia and Herzegovina[c]	..	..	..	..	..	..	244.7	49.2
Bulgaria	20.8	175.5	132.8	55.1	53.9	57.7	95.0	909.3
Croatia[c]	453.7	40.7	466.7	1 444.1	130.5	31.7	12.5	10.7
Czech Republic	3.0	16.5	21.0	22.6	16.9	18.3	17.7	12.1
Hungary[b]	27.2	33.4	24.3	24.9	21.4	21.0	21.7	21.8
Poland[c]	365.5	64.0	39.4	37.8	39.8	30.1	25.8	20.1
Romania[c]	9.7	125.0	173.5	210.7	139.4	55.3	56.7	97.0
Slovakia[b]	4.4	15.0	18.2	21.2	17.6	15.7	13.8	12.0
Slovenia	361.5	68.4	196.7	45.1	27.1	17.1	14.0	12.1
The former Yugoslav Republic of Macedonia[c]	433.6	79.2	1 083.7	454.0	105.8	11.1	3.6	..
Yugoslavia[c]	400.0	100.6	4 886.4	-62.5	229.6	74.1	74.5	41.7
Estonia[d]	..	122.2	570.3	93.3	71.3	34.6	23.8	19.1
Latvia	..	104.5	599.1	111.7	62.7	24.1	14.9	21.6
Lithuania	15.2	183.9	632.5	231.6	59.3	48.8	46.7	20.2
Armenia	6.0	46.9	341.1	737.3	3 345.9	203.9	78.8	25.2
Azerbaijan	4.4	82.9	870.4	700.8	575.7	354.8	53.0	33.2
Belarus	13.4	111.8	919.3	1 073.3	69.4	618.7	58.5	100.3
Georgia[b]	14.3	29.2	413.3	19.3	..	..	..	..
Kazakhstan	11.0	91.5	1 056.0	1 008.6	1 422.8	178.3	30.8	28.0
Kyrgyzstan	11.1	73.1	640.0	615.1	176.3	54.8	29.1	33.8
Republic of Moldova	14.2	90.1	815.0	773.0	284.4	37.1	38.7	30.9
Russian Federation	13.0	94.9	1 065.7	798.2	260.2	131.4	64.3	30.9
Tajikistan	8.0	76.2	550.2	917.5	142.2	139.2	418.3	85.4
Turkmenistan	..	83.8	1 010.1	1 467.7	622.2	686.2	915.3	125.1
Ukraine	..	107.6	1 421.7	2 296.2	747.0	403.5	107.1	..
Uzbekistan	..	82.3	706.1	1 159.3	806.8	278.4	99.8	81.8

Source: UN/ECE Common Database, derived from national statistics.

[a] Calculated from monthly data for Bulgaria, Estonia and Lithuania.

[b] Gross wages in total economy. For Hungary for 1990-1992; for Slovakia for 1990-1991.

[c] Net wages in industry. For Croatia for 1990-1994; for Poland and Romania for 1990-1992. For Bosnia and Herzegovina calculated from monthly data.

[d] Manufacturing for 1991-1993.

APPENDIX TABLE B.10

Merchandise exports of the transition countries, 1980, 1985-1997

(Billion dollars)

	1980	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	56.367	55.020	60.117	63.550	65.020	63.850	61.733	57.241	59.333	62.675	73.261	95.160	99.933	105.895
Albania	0.320	0.242	0.230	0.230	0.230	0.302	0.231	0.101	0.072	0.123	0.139	0.202	0.213	0.137
Bulgaria	7.160	7.389	7.599	7.841	7.554	6.651	5.232	3.433	3.992	3.769	3.935	5.345	4.890	4.914
Czechoslovakia	10.475	10.552	12.160	12.355	12.381	11.988	10.728	11.319	..	..	..	..	..	..
Czech Republic	..	..	..	..	..	..	..	..	8.767 |	14.463	16.206	21.657	21.907	22.528
Slovakia	..	..	..	..	..	..	..	..	3.500	5.458	6.714	8.585	8.822	8.839
Hungary	8.609	8.472	9.170	9.584	9.999	9.673	9.731	10.226	10.681	8.921	10.701	12.867 |	15.704	19.069
Poland	13.071	11.100	13.130	14.095	14.573	14.665	18.291	14.912	13.187	14.202	17.240	22.887	24.440	25.751
Romania	9.217	8.376	8.159	8.580	8.971	8.076	4.570	4.266	4.363	4.892	6.151	7.910	8.085	8.429
Yugoslavia (SFR)	7.514	8.889	9.669	10.866	11.311	12.496	12.950	12.984	14.772	..	..	..	..	..
Bosnia and Herzegovina	..	..	..	..	1.550	2.100	1.850	..	..	..	..	0.024	0.058	0.109
Croatia	..	..	..	..	2.300	2.600	4.020	3.310	4.353	3.709	4.260	4.633	4.512	4.171
Slovenia	1.836	2.111	2.567	2.757	3.278	3.408	4.118	3.874	6.681	6.083	6.828	8.316	8.310	8.372
The former Yugoslav Republic of Macedonia	..	..	..	..	..	0.654	1.113	1.095	1.199	1.055	1.086	1.204	1.147	1.201
Yugoslavia	..	3.810	3.974	4.063	4.298	4.461	4.651	4.704	2.539	..	..	1.531	1.846	2.376
Baltic states	..	..	..	..	..	..	..	..	2.139	4.197	4.324	5.844	6.876	8.443
Estonia	..	..	..	..	..	..	..	..	0.444	0.802	1.305	1.835	2.078	2.911
Latvia	..	..	..	..	..	..	..	..	0.843	1.401	0.988	1.304	1.443	1.672
Lithuania	..	..	..	..	..	..	..	..	0.852	1.994	2.031 |	2.705	3.355	3.860
CIS	..	..	..	..	..	..	..	..	51.125	52.516	62.654	80.008	88.721	88.739*
Armenia	..	..	..	..	..	..	..	..	0.026	0.030	0.058	0.101	0.162	0.138
Azerbaijan	..	..	..	..	..	..	..	..	0.754	0.351	0.379	0.352	0.341	0.403
Belarus	..	..	..	..	..	..	..	1.860	1.061	0.758	1.032	1.776	1.888	1.922
Georgia	..	..	..	..	..	..	..	..	0.068	0.069	0.039	0.058	0.070	0.113
Kazakhstan	..	..	..	..	..	..	..	..	1.398	1.501	1.357	2.367	2.738	3.515
Kyrgyzstan	..	..	..	..	..	..	..	..	0.077	0.112	0.117	0.140	0.112	0.285
Republic of Moldova	..	..	..	..	..	..	..	..	0.167	0.178	0.160	0.279	0.256	0.270
Russian Federation[a]	..	..	..	..	..	..	..	47.266	42.391	44.297	53.001	65.607	71.874	69.473
Tajikistan	..	..	..	..	..	..	..	..	0.108	0.227	0.399	0.497	0.439	0.473
Turkmenistan	..	..	..	..	..	..	..	..	0.908	1.049	0.494	0.951	0.551	0.300
Ukraine	..	..	..	..	..	..	..	..	3.297	3.223	4.653	6.168	6.970	8.646
Uzbekistan	..	..	..	..	..	..	..	..	0.869	0.721	0.966	1.712	3.321	3.200*
Former Soviet Union	57.942	57.317	60.043	63.406	62.016	62.286	59.056	46.660	53.733	56.713	66.979	85.852	95.598	97.182*
Total	114.310	112.337	120.161	126.957	127.035	126.136	120.788	103.901	113.066	119.389	140.240	181.013	195.531	203.077

Source: UN/ECE secretariat, based on national statistical publications and direct communications from national statistical offices.

Note: Data exclude intra-CIS trade, but now include the "new trade" among members of other recently dissolved federal states: former Czechoslovakia (from 1993), SFR of Yugoslavia (from 1992), and the trade of the Baltic states with the former USSR (from 1992). Data excluding the "new trade" were shown in earlier issues of this publication. Changes in the method of recording trade are reflected from 1993 in data for the Czech Republic (inclusion of OPT transactions, etc), from 1995 in Latvia (imports registered c.i.f.) and Lithuania, from 1996 in Hungary; see boxes 3.1.1 and 2.1.1 in UN/ECE, *Economic Bulletin for Europe*, Vol. 48 (1996), p. 42 and Vol. 49 (1997), p. 42.

All trade values for the years 1991-1996 are expressed in dollars at prevailing market exchange rates. For earlier years, values reported in national currencies were adjusted by the UN/ECE secretariat to remove distortions stemming from mutually inconsistent national rouble/dollar cross-rates in the valuation of the then important intra-CMEA trade flows. For details on the revaluation, see the note to table 2.1.4 and the discussion in box 2.1.1 in UN/ECE, *Economic Bulletin for Europe*, Vol. 43 (1991).

[a] Data not adjusted for non-registered flows. Throughout 1996, GosTamkom data revised by the Russian Goskomstat and include of the board sales of fish and other sea products as well as natural gas deliveries under debt repayment agreements with former CMEA countries.

APPENDIX TABLE B.11

Merchandise imports of the transition countries, 1980, 1985-1997

(Billion dollars)

	1980	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	65.443	53.875	59.532	62.033	60.158	61.185	63.408	61.610	68.388	76.285	86.128	117.026	135.684	143.943
Albania	0.320	0.278	0.230	0.230	0.280	0.385	0.381	0.409	0.524	0.421	0.549	0.650	0.913	0.620
Bulgaria	6.321	7.568	8.679	8.222	8.131	7.325	5.584	2.700	4.530	5.120	4.272	5.638	5.074	4.886
Czechoslovakia	10.619	10.216	10.277	12.503	12.180	11.772	11.808	10.962	..	..	..	..	..	..
Czech Republic	..	..	..	..	..	..	..	..	10.368	14.617	17.427	25.265	27.716	26.967
Slovakia	..	..	..	..	..	..	..	..	3.889	6.332	6.634	8.777	11.112	10.224
Hungary	9.188	8.183	9.594	9.859	9.372	8.863	8.797	11.449	11.123	12.648	14.554	15.466	18.144	21.106
Poland	14.705	10.430	12.315	12.686	12.987	12.941	12.619	15.531	16.141	18.758	21.566	29.043	37.137	42.308
Romania	11.061	6.700	6.411	6.355	5.361	5.834	6.889	5.793	6.260	6.522	7.109	10.278	11.435	11.275
Yugoslavia (SFR)	13.229	10.500	12.026	12.178	11.847	14.064	17.330	14.765	..	..	..	..	..	..
Bosnia and Herzegovina	..	..	..	..	1.300	1.850	1.750	..	..	..	..	0.524	1.204	1.555
Croatia	..	..	..	..	2.900	3.750	5.133	3.811	4.346	4.166	5.229	7.510	7.788	9.104
Slovenia	2.463	2.075	2.740	2.722	2.914	3.216	4.727	4.131	6.141	6.501	7.304	9.492	9.421	9.358
The former Yugoslav Republic of Macedonia	..	..	..	..	..	0.934	1.531	1.274	1.206	1.199	1.484	1.719	1.627	1.740
Yugoslavia	..	4.659	4.753	4.851	4.915	5.383	6.701	5.548	3.859	..	..	2.665	4.113	4.801
Baltic states	..	..	..	..	..	..	..	..	1.802	4.101	5.251	8.005	10.110	12.785
Estonia	..	..	..	..	..	..	..	..	0.406	0.896	1.659	2.538	3.231	4.418
Latvia	..	..	..	..	..	..	..	..	0.794	0.961	1.240	1.818	2.320	2.724
Lithuania	..	..	..	..	..	..	..	..	0.602	2.244	2.352	3.649	4.559	5.644
CIS	..	..	..	..	..	..	..	39.294	42.203	33.354	36.745	45.679	48.767	57.452*
Armenia	..	..	..	..	..	..	..	..	0.050	0.086	0.188	0.340	0.578	0.593
Azerbaijan	..	..	..	..	..	..	..	..	0.333	0.241	0.292	0.439	0.621	0.443
Belarus	..	..	..	..	..	..	..	..	0.751	0.779	0.975	1.887	2.369	2.860
Georgia	..	..	..	..	..	..	..	..	0.227	0.167	0.065	0.232	0.416	0.592
Kazakhstan	..	..	..	..	..	..	..	..	0.469	0.494	1.384	1.154	1.296	1.969
Kyrgyzstan	..	..	..	..	..	..	..	..	0.071	0.112	0.108	0.169	0.351	0.274
Republic of Moldova	..	..	..	..	..	..	..	..	0.179	0.184	0.183	0.272	0.415	0.570
Russian Federation [a]	..	..	..	..	..	..	..	39.294	36.984	26.807	28.344	33.117	31.798	38.908
Tajikistan	..	..	..	..	..	..	..	..	0.132	0.374	0.314	0.332	0.286	0.263
Turkmenistan	..	..	..	..	..	..	..	..	0.030	0.501	0.782	0.619	0.924	0.531
Ukraine	..	..	..	..	..	..	..	..	2.049	2.651	2.908	5.488	6.518	7.249
Uzbekistan	..	..	..	..	..	..	..	..	0.929	0.958	1.202	1.630	3.195	3.200*
Former Soviet Union	52.218	54.763	55.016	53.794	58.044	64.983	64.963	45.405	44.166	37.455	41.997	53.684	58.877	70.237*
Total	117.661	108.638	114.548	115.827	118.202	126.168	128.371	106.901	112.554	113.740	128.124	170.710	194.560	214.181

Source: UN/ECE secretariat, based on national statistical publications and direct communications from national statistical offices.

Note: See appendix table B.10.

[a] Data not adjusted for non-registered flows. Throughout 1996, GosTamkom data revised by the Russian Goskomstat and include of the board sales of fish and other sea products as well as natural gas deliveries under debt repayment agreements with former CMEA countries.

APPENDIX TABLE B.12

Balance of merchandise trade of the transition countries, 1980, 1985-1997

(Billion dollars)

	1980	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	-9.076	1.146	0.585	1.517	4.861	2.665	-1.675	-4.369	-9.055	-13.610	-12.866	-21.866	-35.750	-38.048
Albania	–	-0.036	–	–	-0.050	-0.083	-0.150	-0.308	-0.452	-0.298	-0.410	-0.448	-0.701	-0.483
Bulgaria	0.839	-0.179	-1.080	-0.381	-0.577	-0.674	-0.352	0.732	-0.538	-1.352	-0.336	-0.293	-0.184	0.028
Czechoslovakia	-0.144	0.336	1.882	-0.147	0.201	0.216	-1.080	0.356	..	..	..	..	..	..
Czech Republic	..	..	..	..	..	..	..	..	-1.601 |	-0.154	-1.221	-3.608	-5.809	-4.439
Slovakia	..	..	..	..	..	..	..	..	-0.389	-0.874	0.080	-0.192	-2.290	-1.385
Hungary	-0.579	0.289	-0.423	-0.276	0.627	0.810	0.934	-1.223	-0.442	-3.727	-3.853	-2.599 |	-2.440	-2.037
Poland	-1.634	0.670	0.815	1.409	1.586	1.724	5.672	-0.619	-2.955	-4.555	-4.326	-6.156	-12.697	-16.556
Romania	-1.844	1.676	1.748	2.225	3.610	2.242	-2.320	-1.528	-1.897	-1.630	-0.958	-2.368	-3.351	-2.846
Yugoslavia (SFR)	-5.715	-1.611	-2.357	-1.312	-0.536	-1.568	-4.380	-1.780	14.772	..	..	..	..	..
Bosnia and Herzegovina	..	..	..	..	0.250	0.250	0.100	..	..	..	..	-0.500	-1.146	-1.446
Croatia	..	..	..	..	-0.600	-1.150	-1.113	-0.501	0.007	-0.457	-0.969	-2.877	-3.276	-4.933
Slovenia	-0.626	0.035	-0.173	0.035	0.365	0.192	-0.609	-0.257	0.540	-0.418	-0.476	-1.176	-1.111	-0.986
The former Yugoslav Republic of Macedonia	..	..	..	..	..	-0.280	-0.418	-0.179	-0.007	-0.144	-0.398	-0.515	-0.480	-0.539
Yugoslavia	..	-0.849	-0.779	-0.788	-0.617	-0.922	-2.050	-0.844	-1.320	..	..	-1.134	-2.267	-2.425
Baltic states	..	..	..	..	..	..	..	..	0.337	0.096	-0.927	-2.161	-3.234	-4.343
Estonia	..	..	..	..	..	..	..	..	0.038	-0.094	-0.353	-0.703	-1.153	-1.507
Latvia	..	..	..	..	..	..	..	..	0.049	0.440	-0.252 |	-0.514	-0.877	-1.052
Lithuania	..	..	..	..	..	..	..	..	0.250	-0.250	-0.322 |	-0.944	-1.204	-1.784
CIS	..	..	..	..	..	..	..	..	8.922	19.163	25.909	34.330	39.955	31.287*
Armenia	..	..	..	..	..	..	..	..	-0.024	-0.056	-0.130	-0.239	-0.416	-0.456
Azerbaijan	..	..	..	..	..	..	..	..	0.422	0.110	0.087	-0.087	-0.280	-0.040
Belarus	..	..	..	..	..	..	..	1.860	0.310	-0.021	0.057	-0.111	-0.481	-0.938
Georgia	..	..	..	..	..	..	..	..	-0.159	-0.098	-0.026	-0.174	-0.346	-0.479
Kazakhstan	..	..	..	..	..	..	..	..	0.930	1.007	-0.027	1.213	1.442	1.547
Kyrgyzstan	..	..	..	..	..	..	..	..	0.006	–	0.009	-0.029	-0.239	0.011
Republic of Moldova	..	..	..	..	..	..	..	..	-0.012	-0.006	-0.023	0.007	-0.160	-0.300
Russian Federation [a]	..	..	..	..	..	..	..	7.972	5.407	17.491	24.657	32.490	40.076	30.565
Tajikistan	..	..	..	..	..	..	..	..	-0.024	-0.147	0.086	0.165	0.154	0.210
Turkmenistan	..	..	..	..	..	..	..	..	0.879	0.548	-0.288	0.332	-0.374	-0.231
Ukraine	..	..	..	..	..	..	..	..	1.248	0.572	1.745	0.680	0.452	1.397
Uzbekistan	..	..	..	..	..	..	..	..	-0.060	-0.237	-0.236	0.082	0.126	–
Former Soviet Union	5.724	2.554	5.027	9.612	3.972	-2.697	-5.907	1.255	9.567	19.259	24.982	32.169	36.721	26.944*
Total	-3.351	3.700	5.613	11.130	8.833	-0.032	-7.583	-3.000	0.512	5.649	12.116	10.303	0.971	-11.104

Source: UN/ECE secretariat, based on national statistical publications and direct communications from national statistical offices.

Note: See appendix table B.10.

[a] Data not adjusted for non-registered flows. Throughout 1996, GosTamkom data revised by the Russian Goskomstat and include of the board sales of fish and other sea products as well as natural gas deliveries under debt repayment agreements with former CMEA countries.

APPENDIX TABLE B.13

Merchandise trade of the transition countries by direction, 1980, 1985-1997

(Shares in total trade, per cent)

	1980	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe, *to and from:*														
Exports														
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Transition economies	50.0	50.0	55.5	53.0	49.3	46.6	41.1	30.0	24.2	30.0	26.5	26.4	26.8	26.5
Former Soviet Union	27.1	28.5	31.0	29.7	27.2	25.5	22.3	17.9	12.3	9.1	8.6	9.0	9.1	10.2
Eastern Europe	18.6	16.2	18.6	17.8	16.7	15.8	12.7	7.7	6.9	16.0	14.3	14.3	14.9	14.1
Other socialist countries [a]	4.3	5.4	6.0	5.6	5.4	5.3	6.1	4.4	5.0	4.9	3.6	3.2	2.8	2.2
Developed market economies	35.7	35.9	32.3	35.2	38.7	42.6	49.5	59.8	63.2	58.8	63.5	64.4	64.9	66.1
Developing economies	14.3	14.1	12.2	11.8	11.9	10.8	9.4	10.2	12.7	11.2	10.0	9.2	8.3	7.5
Imports														
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Transition economies	47.5	55.0	58.6	54.7	49.3	45.7	36.8	29.3	25.8	29.5	26.7	26.5	25.3	23.7
Former Soviet Union	26.8	32.2	34.5	30.7	26.3	23.5	18.3	20.2	18.0	15.8	13.7	13.2	12.6	11.3
Eastern Europe	17.1	17.6	18.7	18.4	17.6	16.4	12.5	6.3	5.6	11.6	10.9	11.0	10.3	10.1
Other socialist countries [a]	3.6	5.3	5.4	5.6	5.4	5.8	6.0	2.8	2.3	2.2	2.1	2.3	2.4	2.2
Developed market economies	38.7	32.9	32.3	36.1	41.1	44.0	53.3	58.3	64.1	62.4	65.7	65.8	66.7	67.6
Developing economies	13.8	12.0	9.1	9.2	9.5	10.3	9.9	12.4	10.1	8.1	7.6	7.7	8.0	8.9
Former Soviet Union/Russian Federation, *to and from:*														
Exports														
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Transition economies	39.5	41.3	46.4	40.4	35.7	32.4	25.9	30.0	30.7	26.3	23.7	26.2	26.2	26.5
Eastern Europe [b]	30.7	31.6	36.5	31.4	27.5	24.4	18.8	22.9	17.7	17.0	14.1	16.2	13.4	14.0
Other socialist countries [a]	8.8	9.7	9.9	9.0	8.1	8.1	7.1	7.0	13.0	9.3	9.7	10.0	8.9	7.9
Developed market economies	42.2	38.7	31.0	35.3	38.9	41.8	49.5	56.5	57.9	59.7	62.0	59.9	58.1	58.7
Developing economies	18.3	20.0	22.6	24.3	25.4	25.8	24.6	13.5	11.3	14.0	14.3	13.9	15.8	14.8
Imports														
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Transition economies	38.6	41.3	46.5	45.3	38.5	32.9	29.4	31.5	23.7	22.1	18.8	22.2	17.5	18.3
Eastern Europe [b]	31.1	32.1	37.0	36.9	31.3	26.4	23.2	24.5	12.1	10.7	11.7	15.5	8.8	9.3
Other socialist countries [a]	7.4	9.1	9.5	8.4	7.3	6.5	6.2	6.9	11.6	11.4	7.1	6.7	6.7	6.3
Developed market economies	46.4	42.1	40.9	40.7	46.3	50.1	52.9	58.1	62.4	60.6	70.3	69.6	67.8	68.2
Developing economies	15.0	16.7	12.6	13.9	15.2	17.1	17.7	10.4	13.9	17.3	10.9	8.2	14.6	13.5

Source: UN/ECE Common Database, derived from national statistics.

Note: Data for 1980-1990 refer to the east European CMEA countries (Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland and Romania) and to the former Soviet Union. Trade data in national currencies were revalued at consistent rouble-dollar cross-rates (see the note to appendix table B.10). For 1991-1996, eastern Europe covers Bulgaria, former Czechoslovakia (from 1993, Czech Republic and Slovakia including their new mutual trade, which is responsible for the substantial shifts in trade shares in that year), Hungary, Poland and Romania, and the second panel reflects trade of the Russian Federation only.

[a] China, Cuba, Democratic People's Republic of Korea, Mongolia, Viet Nam, former SFR of Yugoslavia.

[b] Former CMEA countries.

APPENDIX TABLE B.14

Exchange rates of the transition countries, 1980, 1985-1997

(Annual averages, national currency units per dollar)

	Unit [a]	*1980*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Albania	lek	..	..	..	..	..	..	8.90	24.20	75.03	102.06	94.62	93.14	104.33	148.93
Bulgaria	lev	0.86	1.03	0.94	0.87	0.83	0.84	0.79	17.45	23.42	27.85	54.13	67.08	177.88	1681.87
Czechoslovakia	koruna	5.37	18.51	16.20	14.79	14.37	15.06	18.56	29.56	28.30	..	..	..	..	..
Czech Republic	koruna	..	..	..	..	..	..	..	..	..	29.15	28.79	26.54	27.14	31.70
Slovakia	koruna	..	..	..	..	..	..	..	..	..	30.80	31.93	29.71	30.68	33.62
Hungary	forint	32.64	50.12	45.83	46.97	50.41	59.07	63.21	74.73	78.98	91.91	105.11	125.69	152.65	186.79
Poland	zloty [b]	3.05	147.17	175.28	265.08	430.64	1 439	9 500	10 576	13 627	18 136	22 723	2.42	2.70	3.28
Romania	leu	4.47	17.50	16.80	16.00	16.00	16.00	22.43	71.84	307.98	760.12	1 654	2 033	3 085	7 183
Yugoslavia (SFR)	dinar [c]	24.64	270.16	379.22	737.00	2 523	28 760	11.32	19.64	..	..	..	..	..	..
Bosnia and Herzegovina	dinar	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Croatia	kuna [d]	..	..	..	..	..	..	..	18.80	264.30	3 578	6.00	5.23	5.43	6.10
Slovenia	tolar	..	..	..	..	..	..	..	19.69	508.07	23.26	43.25	38.05	39.92	50.40
The former Yugoslav Republic of Macedonia	denar [e]	..	..	..	..	..	..	..	27.57	81.29	113.24	128.81	118.52	135.37	159.69
Yugoslavia	dinar [f]	..	..	..	..	..	..	..	19.64	508.07	..	..	4.74	4.96	5.72
Estonia	kroon [g]	..	..	..	..	..	..	..	..	12.11	13.22	12.98	11.46	12.03	13.88
Latvia	lats [h]	..	..	..	..	..	..	..	..	..	0.67	0.56	0.53	0.55	0.58
Lithuania	litas [i]	..	..	..	..	..	..	..	..	..	4.37	3.98	4.00	4.00	4.00
Armenia	dram	..	..	..	..	..	..	..	..	..	8.66	288.35	405.93	413.47	490.70
Azerbaijan	manat	..	..	..	..	..	..	..	..	..	..	1 169	4 417	4 295	3 987
Belarus	rouble [j]	..	..	..	..	..	..	..	..	..	2 177	4 017	11 538	13 472	26 729
Georgia	lari [k]	..	..	..	..	..	..	..	..	..	..	1.10	1.29	1.26	1.30
Kazakhstan	tenge	..	..	..	..	..	..	..	..	..	..	35.54	60.95	67.30	75.43
Kyrgyzstan	som	..	..	..	..	..	..	..	..	..	..	10.86	10.83	12.81	17.37
Republic of Moldova	leu	..	..	..	..	..	..	..	..	..	..	4.07	4.50	4.60	4.62
Russian Federation	rouble [l]	0.65	0.84	0.70	0.63	0.61	0.63	0.59	1.74	192.75	927.46	2 204	4 559	5 121	5 785
Tajikistan	rouble	..	..	..	..	..	..	..	..	..	..	..	107.59	292.89	560.64
Turkmenistan	manat	..	..	..	..	..	..	..	..	..	..	19.50	110.42	3 509	4 143
Ukraine	hryvnia [m]	..	..	..	..	..	..	..	..	..	4 796	31 700	147 314	1.83	1.86
Uzbekistan	sum [n]	..	..	..	..	..	..	..	..	..	932.15	9.96	29.81	40.15	66.43
Memorandum item:															
Ex-GDR Länder	mark [o]	3.30	8.14	8.14	8.14	8.14	8.14	8.14	1.66	1.56	1.65	1.62	1.43	1.50	1.73

Source: UN/ECE Common Database, derived from national, IMF and CIS statistics. Annual averages are unweighted arithmetic averages of monthly values. Change or redenomination of currency is indicated by a vertical bar.

Note: Under the central planning system with its state foreign trade monopoly, exchange rates served primarily statistical and accounting purposes (notably the conversion of foreign trade values for statistics expressed in domestic currency), without direct impact on domestic price formation. Market-based exchange rates and a meaningful link to domestic currency values emerged only with the transformations from 1989 onward. The official exchange rates of the earlier period are therefore not suitable for the conversion to dollars of macroeconomic and other data of these countries expressed in domestic currency. These strictures should be kept in mind in the interpretation and use of the data for the 1980s shown above.

[a] Currency unit of the last period shown. For prior periods, see footnotes.

[b] The zloty was redenominated at 1:10,000 from 1 January 1995.

[c] The dinar was redenominated 1:10,000 from 1 January 1990.

[d] The kuna replaced a Croat dinar on 3 May 1994 at 1:1,000; the 1994 average is shown in kuna terms.

[e] The denar (which had replaced the Yugoslav dinar 1:1 on 26 April 1992) was redenominated 1:100 on 1 May 1993; the 1993 average is shown in terms of that unit.

[f] The dinar was further redenominated on 1 July 1992 (1:10), 1 October 1993 (1:1 million), 1 January 1994 (1:1 trillion) and 24 January 1994 (1:13 million). Average annual exchange rates not available after 1992.

[g] The kroon replaced the Soviet rouble in June 1992 with a peg to the deutsche mark (8:1); the average shown for 1992 refers to June-December.

[h] The lats replaced an earlier Latvian rouble at 1:200 on 18 October 1993; the 1993 average is shown in lat terms.

[i] The litas replaced the earlier talonas at 1:100 on 1 June 1993; the 1993 average is shown in litas terms.

[j] The Belarus rouble was redenominated 1:10 on 10 August 1994; the 1994 average here assumes this applied to the entire year. Annual averages were computed from end-of-period monthly rates.

[k] The lari replaced a lari-kupon on 25 September 1995; the annual average for 1994 is shown in million lari-kupon, and that for 1995 in lari.

[l] 1980-1991: Soviet rouble/dollar rate used in the conversion of foreign trade data for statistical purposes.

[m] The hrynvia replaced the former karbovanets on 2 September 1996 at 1:100,000; the average for 1996 is shown in hryvnia terms.

[n] Sum-kupon in 1993.

[o] German Democratic Republic mark through 1990, deutsche mark thereafter.

APPENDIX TABLE B.15

Current account balances of the European transition countries, 1990-1997

(Million dollars)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	-3 914	-2 502	-862	-7 338	-4 197	-1 090	-13 212	-14 552
Albania	-118	-168	-51	15	-43	-15	-107	-271
Bulgaria	-1 710	-77	-360	-1 098	-25	-26	16	446
Croatia [a] [b]	-500	-589	329	600	786	-1 283	-881	-2 283
Czech Republic	-122	1 709	-456	456	-787	-1 369	-4 292	-3 156
Hungary [c]	127	267	324	-3 455	-3 911	-2 480	-1 678	-981
Poland [c] [d]	716	-1 359	-269	-2 329	-944	5 455	-1 352	-4 268
Romania [c]	-1 650	-1 369	-1 460	-1 174	-428	-1 774	-2 571	-2 486
Slovakia	-767	-786	173	-559	712	646	-2 098	-1 347
Slovenia [a]	518	129	926	192	600	-23	39	70
The former Yugoslav Republic of Macedonia	-409	-259	-19	15	-158	-222	-288	-276
Baltic states	..	..	681	371	-71	-816	-1 425	-2 031
Estonia	..	..	153	40	-178	-185	-423	-608
Latvia	..	..	207	417	201	-16	-279	-441
Lithuania	..	..	322	-86	-94	-614	-723	-981
CIS	-6 608	2 947	-4 881	1 359	7 099	4 387	6 349	-2 247
Armenia	..	..	..	-67	-106	-279	-291	-305
Azerbaijan	..	..	..	..	..	-401	-931	-916
Belarus	..	..	131	-404	-506	-567	-516	-799
Georgia	..	..	..	..	-278	-218	-277	-347
Kazakhstan	..	..	..	..	..	-518	-752	-954
Kyrgyzstan	..	..	..	-88	-83	-233	-423	-137
Republic of Moldova	..	..	..	-155	-82	-95	-188	-296
Russian Federation [e]	-6 300	2 500	-5 700	2 700	9 284	7 938	12 096	3 342
Tajikistan	..	..	..	-208	-170	1	-110	..
Turkmenistan	-308	447	926	775	85	-39	2	..
Ukraine	..	..	..	-765	-1 163	-1 152	-1 185	-1 335
Uzbekistan	..	..	-238	-429	118	-49	-1 075	-500 [f]
Total	-10 214	-2	-5 750	-5 591	3 265	4 218	-4 431	-15 670

Source: National balance of payments statistics; IMF for Tajikistan, Turkmenistan and Uzbekistan.

[a] Excludes transactions with the republics of the former SFR of Yugoslavia: Croatia (1990-1992) and Slovenia (1990-1991).

[b] Data for 1993-1997 were revised in 1998 according to a new methodology.

[c] Convertible currencies. Hungary until 1995; Romania until 1992.

[d] As of 1995 the current account of Poland includes non-classified current account transactions. Excluding this item the current account balance was a $2,480 million deficit in 1995.

[e] 1990-1993 excluding transactions with the Baltic and CIS countries.

[f] Official forecasts.

APPENDIX TABLE B.16

Inflows of foreign direct investment[a] in the transition countries, 1990-1997

(Million dollars)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Eastern Europe	461	2 329	3 120	4 106	3 479	9 159	7 573	9 076
Albania[b]	..	..	20	58	53	70	90	48
Bulgaria	4	56	42	40	105	90	109	498
Croatia	..	..	16	95	102	88	529	346
Czech Republic	132	513	1 004	654	869	2 562	1 428	1 300
Hungary	311	1 459	1 471	2 339	1 146	4 453	1 983	2 085
Poland[b]	10	117	284	580	542	1 134	2 768	3 077
Romania	-18	37	73	94	341	419	263	1 224
Slovakia	18	82	100	134	170	157	206	161
Slovenia	4	65	111	113	128	176	185	321
The former Yugoslav Republic of Macedonia[b]	..	..	..	..	24	9	11	16
Baltic states	..	..	101	236	471	457	684	1 034
Estonia	..	..	58	160	225	205	150	262
Latvia	..	..	43	45	214	180	382	418
Lithuania	..	..	..	30	31	73	152	355
CIS	-400	-100	830	1 495	1 603	3 656	5 637	10 593
Armenia	..	..	..	..	8	–	18	43
Azerbaijan	..	..	..	20	22	155	591	1 051
Belarus	..	..	..	..	9	15	73	192
Georgia	..	..	2	3	8	6	40	203
Kazakhstan	..	..	100	228	519	984	1 674	2 106
Kyrgyzstan[b]	..	..	..	10	38	96	47	75
Republic of Moldova	..	..	..	..	12	64	24	60
Russian Federation[b]	-400	-100	700	900	640	2 016	2 479	6 241
Tajikistan[b]	..	..	8	9	12	13	13	..
Turkmenistan[b]	..	..	11	79	103	64	108	..
Ukraine	..	..	..	198	159	267	521	623
Uzbekistan[b]	..	..	9	48	73	-24	50	..
Total	61	2 229	4 051	5 837	5 553	13 272	13 894	20 703

Source: National balance of payments statistics; IMF for Tajikistan, Turkmenistan and Uzbekistan.

[a] Inflows into the reporting country.

[b] Net of residents' investment abroad. Bulgaria, 1990-1994; Poland, 1990-1995; and Russian Federation, 1990-1992.

Corrections to Economic Survey of Europe, 1998 No. 1

Replace page ix with:

ABBREVIATIONS

ASEAN	Association of South-East Asian Nations
BEC	broad economic categories
BIS	Bank for International Settlements
CEFTA	Central European Free Trade Agreement
CETE	central European transition economies
c.i.f.	cost, insurance and freight
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
COMTRADE	Commodity Trade Database (of United Nations Statistical Office)
CPI	consumer price index
DIW	German Institute for Economic Research
DMEs	developed market economies
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECLAC	Economic Commission for Latin America and the Caribbean
ECOFIN	Council of the Economic and Finance Ministers (of the European Union)
ECU	European currency unit
EFF	Extended Fund Facility (of IMF)
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	economic and monetary union
ERM	exchange rate mechanism
ESAF	Enhanced Structural Adjustment Facility (of IMF)
EU	European Union
FDI	foreign direct investment
f.o.b.	free on board
G-7	Group of Seven
GDP	gross domestic product
GDR	global depository receipt
GNP	gross national product
GSP	generalized system of preferences
HICP	harmonized indices of consumer prices
HS	Harmonized Commodity Description and Coding System
HWWA	Hamburg Institute for Economic Research
IIF	Institute of International Finance, Inc.
ILO	International Labour Office
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification
LIBOR	London Inter-bank Offered Rate
MFN	most favoured nation

Page 8, first column, last text line

For former *read* latter

Page 139, table 3.6.6 title

For 1990-1997 *read* 1993-1997

Page 167, second column, first paragraph

For (iv) Predictability in The Soviet system, … *read*

(iv) Predictability in administration

The Soviet system, …

Page 171, table 4.2.4, columns 5 and 6

Replace Former Soviet Union/CIS and Rest of world *with* Total

Page 173, second column, line 14

For 1996 *read* 1997

Page 181, table 4.5.3 source

For Truda v Stranakh Sodrutzestva *read* truda v stranakh Sodruzhestva

Page 204, appendix table B.7

The entry for Armenia 1994 *should read* 4 964.0

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* * * * *

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